

AGENDA – October 5, 1999 Business Taxes Committee Meeting
Proposed Amendments to Regulation 1540, *Advertising Agencies, Commercial Artists and Designers*

<p>Action 1 – Consent</p> <p>Amended Regulation 1540, <i>Advertising Agencies, Commercial Artists and Designers</i>, except for subdivision (d)(1)</p>	<p>Adopt proposed language as agreed upon by staff and industry. Operative Date: None Implementation: Upon OAL approval</p>
<p>Action 2 – Application of Tax to Transfers of Tangible Personal Property Resulting from Creative Design or Concept Development Services When the Contract of Sale Provides That the Commercial Artist or Designer Will Pass to the Client Title or the Right to Permanent Possession</p> <p>Amended Regulation 1540 (d)(1), <i>Services</i>.</p>	<p>Adopt either: 1) Staff's proposed language (Exhibit 1, page 15); or</p> <p style="text-align: center;">2) Industry proposed language (Exhibit 1, page 15)</p>
<p>Action 3 – Authorization to Publish</p>	<p>Direct the publication of the proposed amendments to Regulation 1540 as adopted in the above actions.</p>

AGENDA – October 5, 1999 Business Taxes Committee Meeting
Proposed Amendments to Regulation 1540, *Advertising Agencies, Commercial Artists and Designers*

ACTION 1 – Consent Items

Item	Comments
1. Exhibit 1. Pages 1-21, Amended Regulation 1540, <i>Advertising Agencies, Commercial Artists and Designers</i> , except subdivision (d)(1)	Accept proposed language agreed upon by staff and industry.

AGENDA – October 5, 1999 Business Taxes Committee Meeting
Proposed Amendments to Regulation 1540, *Advertising Agencies, Commercial Artists and Designers*

Action Item	Staff Proposed Language	Industry Proposed Language
<p>ACTION 2,</p> <p>Application of Tax to Transfers of Tangible Personal Property Resulting from Creative Design or Concept Development Services When the Contract of Sale Provides That the Commercial Artist or Designer Will Pass to the Client Title or the Right to Permanent Possession</p> <p>Exhibit 1, Page 15</p>	<p>Amended Regulation 1540(d)(1):</p> <p>Services. Services performed to convey ideas, concepts, looks or messages to a client may result in a transfer, enhancement or revision of either electronic artwork, hard copies of electronic artwork, or copies of manually prepared artwork. If charges for such services are separately stated as “design charges,” “preliminary art,” “concept development,” or any other designation that clearly indicates that the charges are for such services and not for finished art, they are nontaxable unless the contract of sale provides that the commercial artist or designer will pass to the client title or the right to permanent possession of the electronic media or hard copy.</p> <p>A commercial artist or designer who provides nontaxable services is the consumer of tangible personal property used in the performance of such services and tax applies to the sale of property to the commercial artist or designer.</p>	<p>Amended Regulation 1540(d)(1):</p> <p>Services. Services performed to convey ideas, concepts, looks or messages to a client may result in a transfer, enhancement or revision of either electronic artwork, hard copies of electronic artwork, or copies of manually prepared artwork. If charges for such services are separately stated as “design charges,” “preliminary art,” “concept development,” or any other designation that clearly indicates that the charges are for such services and not for finished art, they are nontaxable.</p> <p>A commercial artist or designer who provides nontaxable services is the consumer of tangible personal property used in the performance of such services and tax applies to the sale of property to the commercial artist or designer.</p>

AGENDA – October 5, 1999 Business Taxes Committee Meeting
Proposed Amendments to Regulation 1540, *Advertising Agencies, Commercial Artists and Designers*

Action Item	Staff Proposed Language	Industry Proposed Language
ACTION 3, Authorization to Publish		

Issue Paper

99-046

10/5/99



BOARD OF EQUALIZATION
KEY AGENCY ISSUE

- ☐ Board Meeting
- ☒ Business Taxes Committee
- ☐ Customer Services Committee
- ☐ Legislative Committee
- ☐ Property Tax Committee
- ☐ Technology & Administration Committee
- ☐ Other

REGULATION 1540 - ADVERTISING AGENCIES, COMMERCIAL ARTISTS AND DESIGNERS

I. Issue

Should Regulation 1540 be amended, as jointly developed by industry and staff, to incorporate industry's proposed amendments, and be restructured to clarify the application of tax to the activities of advertising agencies and commercial artists and designers?

II. Staff Recommendation

Staff recommends that Regulation 1540's provisions related to advertising agencies be amended to: 1) generally treat advertising agencies as agents of their clients, 2) explain under what circumstances advertising agencies are retailers, 3) define additional nontaxable services provided by advertising agencies, 4) provide simplified methods to report retail sales, and 5) make the regulation consistent with other sales and use tax regulations, particularly Regulation 1541, *Printing and Related Arts*.

Staff also recommends that Regulation 1540's provisions related to commercial artists be amended to: 1) Clarify when transfers of images on electronic media are nontaxable, 2) allow as nontaxable 75% of a lump-sum billing for creative and development services (currently defined as preliminary art) and finished art, 3) treat as nontaxable any receipts for the sale of additional copyrights or royalties when they are received more than one year after the original transfer of artwork on physical media, 4) require specific passage of title for tax to apply to transfers of tangible personal property produced as a part of creative or development services, 5) exclude from tax transfers of single copies of blueprints, diagrams, and instructions that artists provide to clients as the result of environmental graphic design services, and 6) specifically exclude from tax charges for designing, editing, or hosting an electronic website when no tangible personal property is transferred.

In recognition of technological change, the regulation is updated to conform to the industry's use of computer hardware and software to produce print advertising and artwork.

III. Other Alternative(s) Considered

Alternative 1

As proposed by the advertising industry, adopt staff's recommendation except that transfers of tangible personal property resulting from creative or development services would be nontaxable even if a contract of sale passes title to or permanent possession of the property to the client.

Issue Paper Number: **99-046**

IV. Background

Discussion - Advertising Agencies

In a June 22, 1999 letter, the law firm of Bewley, Lassleben & Miller representing the American Association of Advertising Agencies, (hereinafter referred to as the advertising industry), proposed ten amendments to Regulation 1540 for consideration by staff and for discussion at the October 5, 1999 Business Taxes Committee meeting. Several of the proposals concerned advertising agencies exclusively and a few were of concern to both advertising agencies and commercial artists. Staff also received two proposals from the law firm of Nielsen, Merksamer, etal., on behalf of the Graphic Artists Guild (hereinafter referred to as the graphic arts industry). These proposals dealt with amendments concerning reproduction and other intangible rights and will be discussed in the section on graphic artists.

Staff and the advertising industry held three meetings on proposed amendments. The advertising industry expressed two main concerns with the current Regulation 1540: 1) the difficulties of complying with the current regulation, and 2) the obsolescence of the current regulation because of technological advances that have significantly changed industry practices.

According to the advertising industry, factors that make compliance difficult include:

- Acquiring written evidence of agent status with a client. The advertising industry noted that many clients will not sign a contract or agreement of agent status, even if there is an agent/client relationship. Consequently, agencies, particularly smaller agencies, are audited and are found to be retailers. The resulting audit liabilities are burdensome.
- Determining what charges are taxable. If an advertising agency does not qualify as an agent, the current regulation treats the agency as a retailer. As a retailer, the regulation requires the selling price of tangible personal property fabricated or sold by an advertising agency to include not only the cost of materials and direct labor, but also services that are included as part of the sale. The advertising industry contends that many of the services it provides to its clients are excludable from tax because they are not directly related to the fabrication or sale of tangible personal property. Rather, these services are related to preliminary steps such as conceptualization and management of an advertisement or advertising campaign. The advertising industry contends that the regulation does not have a clear delineation between charges that are excludable and those that are taxable. As a result, advertising agencies are required to expend excessive time and expense in efforts to support claimed exemptions that are disallowed by auditors.

The advertising industry suggested that one solution to these problems was to treat advertising agencies as service providers only. Under this proposal, all sales of tangible personal property would be incidental to the services provided.

In regard to the second issue, the advertising industry contended that the regulation is obsolete in its treatment of the processes for producing print advertisements. The current regulation is based on a manual process. In this process, various employees or contractors supply components of a print advertisement, for example, copy, typesetting, and artwork. These components are ultimately

Issue Paper Number: **99-046**

combined on a board to produce camera-ready art. A picture is taken of the board and is used to make various printing aids that are used to produce the actual printing plate. As a result of this process, the regulation makes a distinction between activities that are part of the creative, conceptual process, that is, preliminary art, and the final product of this process, that is, the final, finished, or camera-ready art. If separately stated and the other criteria are met, the preliminary art is exempt. The finished art is taxable. The advertising industry contended that technological changes, namely the use of computer hardware and software to produce both artwork and printing aids, have eliminated most of the manual process. Digital production is primarily completed on computers and is an on-going process with very little production of tangible personal property until the actual production of plates. In some cases, a digital file is created and is used to print directly from the press without the fabrication of plates. As a consequence, the advertising industry felt that distinctions between preliminary and final art were no longer reflective of industry practices. In addition, the advertising industry indicated that the regulation's emphasis on the manual process caused problems when they were audited because auditors did not understand how the business operated.

The advertising industry suggested that the regulation be amended to recognize the technological changes made to their operations.

Subsequent to the initial discussion of these issues, the advertising industry submitted a proposed rewrite of the regulation, which embodied its concerns. The proposed major amendments were to:

- Treat advertising agencies primarily as service providers or agents.
- Allow an advertising agency to rebut the presumption that issuance of a resale certificate negated its status as an agent.
- Exclude consultation, account planning, and quality control services from taxable measure.
- Replace the concept of preliminary art with the concept of creative art services.
- Rebuttably presume that advertising agencies pass title to certain tangible personal property to their clients prior to use.
- Update the regulation to conform to the industry's use of computer hardware and software to produce print advertising and artwork.

During the discussion of these proposals, the advertising industry presented documentation of the impact of technological changes on the advertising industry. Based on this presentation and further discussion of industry practices, staff and the advertising industry agreed on the following proposed amendments to Regulation 1540:

- Advertising agencies are to be generally treated as agents of their clients. As agents, tax is due on the selling price of the tangible personal property to the agency. Fees associated with the acquisition and transfer of tangible personal property to a client are nontaxable. If an advertising agency acting as an agent issues a resale certificate when purchasing tangible personal property for its client, it is allowed to present evidence of agent status and, if the status is accepted, will be liable for tax only on the purchase price from the supplier.

FORMAL ISSUE PAPERIssue Paper Number: **99-046**

- Advertising agencies may qualify as retailers by electing non-agent status or making lump-sum sales of tangible personal property. Advertising agencies are always retailers of tangible personal property that is manufactured or produced by their employees in-house.
- When an advertising agency makes a lump-sum sale of tangible personal property, tax applies to the lump-sum selling price unless it is a sale of artwork. If an advertising agency does not bill lump-sum, it may calculate a “taxable selling price” by using the cost of materials plus the cost of production or printing aids, direct labor, and a reasonable markup.
- In recognition of changes in industry practices, the language concerning preliminary and finished artwork is replaced with language about “electronic” or “digital” artwork. The application of tax follows Regulation 1502; that is, transfers are nontaxable if made through remote telecommunications or through the seller downloading the file on the client’s computer. Transfers effected through electronic media such as diskettes or compact discs are subject to tax. The proposed amendment also allows the exclusion found in Regulation 1541 for electronic and digital pre-press instruction. Application of tax to transfers of artwork is discussed in the section on graphic artists.
- Certain services are specifically treated as nontaxable. These include concept development fees, account planning services, and quality control supervision.

In addition to the above proposed amendments, the regulation was rearranged to first present situations under which an advertising agency’s transactions are nontaxable. It then progresses to taxable transactions. Finally, language was included to ensure transactions affected by other regulations are treated consistently. Such transactions included audio or movie productions (Regulations 1527 and 1529), printing aids and digital pre-press instructions (Regulation 1541), and transfers of data on electronic media (Regulation 1502).

Discussion – Graphic Arts Industry

The graphic arts industry expressed the same concerns as the advertising industry about the difficulties of complying with Regulation 1540 and its obsolescence. The primary difficulty expressed by the graphic arts industry was valuing and documenting the exclusion for preliminary art. The graphic arts industry noted that there rarely is a clear dividing line between the cessation of conceptual development or design and the production of finished art. This lack of a clear line has been aggravated by technological change.

The graphic arts industry generally agreed with the proposed language on electronic or digital artwork, and concurred that the transfer of artwork through remote telecommunications or through the seller’s downloading on the customer’s computer should be nontaxable. However, the graphic arts industry disagreed that tax applies to artwork transferred to a client on electronic media such as a diskette or compact disc when it was not downloaded by the seller. The graphic arts industry felt that both transactions are simply transfers of the ideas embodied in the digital code; that the actual transfer of the medium is immaterial and should not be a determining factor in the application of tax. Staff was of the opinion that transfers of digital files should be consistent with the provisions of Regulation 1502, which excludes from tax only programs or files transferred through remote telecommunications

FORMAL ISSUE PAPERIssue Paper Number: **99-046**

or those downloaded onto the client's computer by the seller. After discussing this issue with staff, the graphics arts industry decided not to pursue it any further.

The graphic arts industry was also concerned about staff disallowing claimed exemptions for creative and development services on audits. Staff and the graphics arts industry agreed that separately stated charges for these services were not subject to tax. However, staff is of the opinion that charges for the transfer to a client of title or possession to tangible personal property resulting from these services are gross receipts and are subject to tax. The advertising industry disagreed with staff on this issue and the difference was not resolved.

In addition to the above issues, the graphic arts industry had two concerns specific to their industry: 1) the application of tax to transfers of artwork for purposes of reproduction without a corresponding transfer of title (reproduction rights), and 2) the application of tax to a use of artwork that occurs a significant period of time after the initial transfer for reproduction (subsequent use of copyrights).

The graphic arts industry asserts that the charge for reproduction rights should not be taxable in its entirety because a material portion is attributable to the sale of intangible property, for example, a copyright. Further, the industry feels that the use of artwork after a significant period of time is merely the exercise of a bare copyright and should be completely nontaxable. The graphic arts industry bases their reproduction rights position on interpretations of statutes, treatment of similar transactions in other regulations, and a Board decision. Specifically, industry cites Revenue and Taxation Code Section 6011(c)(1), Regulations 1502 and 1529, and the Board's decision in the *Appeal of Intel Corporation* case.

Staff is of the opinion that the Sales and Use Tax Law allows full taxation of transactions that include transfers for reproduction only. Staff's position is based on an analysis of the same code section, regulations, and Board decision cited by the graphic arts industry and a further analysis of precedents established by the Revenue and Taxation Code, case law, legislative action, and current litigation. A more detailed discussion of this issue is included in the analysis subsection in the discussion of Regulation 1540 on page 10.

Because the graphic arts industry and staff could not reach consensus on the issue of reproduction rights, staff offered to simplify reporting for graphic artists by standardizing the percentage that could be claimed for creative and development services. In particular, staff proposed a presumptive exclusion for preliminary art be established on lump-sum billings of commercial artwork. The graphics industry proposed a 75% presumptive exclusion. Staff agreed to this percentage on the basis that it represented a reasonable industry-wide allocation between charges for preliminary and finished art. Industry agreed and decided not to pursue the reproduction rights issue any further.

To resolve the issue of the subsequent use of copyrights, industry proposed that any exercise of a copyright that occurred more than 180 days after the physical transfer of the artwork be considered merely the transfer of a copyright. Staff proposed one year instead of 180 days, but otherwise agreed with industry's proposal with the reservation that the transfers be made by the original owner of the copyright. That is, the exclusion cannot be extended to stock photo or artwork houses. Industry agreed with these two changes.

FORMAL ISSUE PAPERIssue Paper Number: **99-046**

Staff and industry also discussed two specific types of transactions: 1) tangible personal property resulting from environmental graphic design services and 2) charges resulting from designing, editing, or hosting an electronic website. Industry requested an exclusion for commercial artists engaged in environmental graphic design (the process of designing and placement of signage primarily on commercial buildings). Industry explained that the commercial artist was providing services and products identical to those provided by architects, however, the commercial artist was taxed and the architect was not. Products consist of blueprints, diagrams, and instructions for sign placement. Staff agreed that the exclusion should be allowed. Staff also agreed with excluding activities associated with websites provided there was no transfer of tangible personal property.

In summary, the following amendments for the graphic arts industry are proposed for Regulation 1540:

- The presumption that, on a lump-sum charge for the transfer of commercial artwork, 75% of the charge is for nontaxable conceptual and design services.
- Any receipts from the use of a reproduction right occurring more than one year after the original transfer of the artwork are excluded from tax.
- Separately stated charges for preliminary art are nontaxable.
- Charges for the transfers of single copies of blueprints, diagrams and instructions resulting from environmental graphic design are excluded from tax. Additional copies are taxable on the selling price to the client.
- Charges resulting from designing, editing or hosting an electronic website are excluded from tax provided there is no transfer of tangible personal property.

Discussion – Regulation 1540**History**

Regulation 1540 is the successor to Board of Equalization Ruling No. 1 (effective 1933), and Ruling No. 2 (an amendment of Ruling No. 1, effective 1950). Ruling No. 2 was renumbered as Regulation 1540 in 1971. The current form of the regulation results from extensive amendments in 1974.

The rulings and Regulation 1540 apply Sales and Use Tax Law Sections 6006, 6010.3, 6012, and 6015 to transactions by advertising agencies, commercial artists and designers. Section 6006 defines a “sale” as “any transfer of title or possession, exchange, or barter...in any manner or by any means whatsoever...for consideration.” Section 6010.3, “Sale” and “purchase” – printing materials, provides a specific exemption, effective November 13, 1968, for the fabrication or transfer of composed type. Section 6012 defines “gross receipts” as the “total amount of the sale...of the retail sales of retailers, valued in money.” Section 6012(b)(1) states that the total amount of the sale includes “any services that are part of the sale.” Section 6015 defines “retailer” as every seller making “any retail sale or

FORMAL ISSUE PAPERIssue Paper Number: **99-046**

sales of tangible personal property” or “every person engaged in the business of making sales for storage, use or other consumption.”

The basic framework of Regulation 1540 was established by Ruling No. 2. In this ruling, the Board recognized that the activities of advertising agencies could include both taxable and nontaxable transactions and that advertising agencies sometimes acted as agents of their clients. If an advertising agency qualified as an agent, a purchase on behalf of its client was regarded as a retail sale and tax applied to the gross receipts. If the advertising agency did not qualify as an agent, tax applied to the total amount the advertising agency received from a sale of tangible personal property to a client. The ruling also provided general guidelines for determining agent status. These included the nature of the contract, the conduct of the parties involved, and the facts and circumstances of the transaction. Ruling No. 2 also allowed a general exemption for art produced for the purpose of visualizing an idea. However, it specifically stated that tax applied to artwork sold for reproduction or display.

A 1961 amendment to Ruling No. 2 added detail on the application of tax to the different charges or services of an advertising agency:

- Services unconnected with a sale of tangible personal property were not taxable. Examples included the writing of original manuscripts, news releases, or advertising copy, and the placement or delivery of advertising. Charges for services in support of nontaxable activities were not taxable. Support included supervision, consultation, research, and travel expenses.
- Commissions or fees charged in connection with nontaxable services were not taxable.
- Tax applied to the entire charge for tangible personal property sold to clients. (It should be noted that “entire charge” was not defined).

The amendment also introduced the concept of “preliminary art” which it defined as “roughs, visualizations, comprehensives or layouts prepared for acceptance by clients before a contract is entered into or approval is given for finished art.” The amendment provided that separately stated charges for preliminary art were not taxable unless the art was incorporated into finished art. Separately stated charges had to be clearly identified on the billing as being for preliminary art. Proof of ordering the final art was to be evidenced by purchase orders of the buyer, or work orders or other records of the seller. “Finished art” was defined as the final art used for reproduction by photomechanical or other processes.

In 1971, Ruling No. 2 was renumbered as Regulation 1540. The regulation substantively attained its current form with the amendments of 1974, which primarily dealt with two issues: 1) “agent” status and its effect on the application of tax, and 2) the application of tax to services rendered by the advertising agencies in connection with sales of tangible personal property.

In accordance with Civil Code Section 2295, the 1974 amendments defined an agent as one who represents a principal in dealings with third persons. Further, an advertising agency may either act as an agent for its clients or it may act on its own behalf. If it qualifies as an agent, an advertising agency is neither a purchaser nor seller of property purchased on behalf of its clients and the advertising agency’s charge to the client for the property is not taxable. If it is not acting as an agent, the

FORMAL ISSUE PAPERIssue Paper Number: **99-046**

advertising agency is a consumer of items purchased and a retailer of the tangible personal property it sells. The only exception is property purchased for resale.

To establish its agent status, an advertising agency must: 1) clearly disclose to the supplier the name of its client, 2) obtain and retain written evidence of agent status prior to the acquisition, and 3) bill the client the same amount that was paid to the supplier. In addition, the advertising agency must make no use of the property for its own account and should separately invoice its client for the reimbursement. Advertising agencies making purchases on behalf of clients should not issue resale certificates for purchases.

Even if the advertising agency qualifies as an agent, it is still considered a retailer of items produced or fabricated by its employees in-house. Consequently, it is not an agent in regards to materials acquired for incorporation into property prepared by its employees.

The 1974 amendments also note that client billings may include not only the selling price of tangible personal property, but compensation for expenses and services related to the production of the property. Tax applies to the total amount of a retail sale whether or not the property is acquired from an outside source or is prepared by an employee. The revision also lists specific types of charges that are taxable. These charges include labor or service cost for the production of the property, supervision, consultation, research, postage, model or talent fees, typography or other services involved in the production, and telephone or travel expenses.

If an advertising agency includes the selling price of the property in some other charge such as a fee or commission, tax applies to the "fair retail selling price," defined as: 1) the net labor costs of the employees plus an allowance for overhead and profit of not less than 100 percent of the labor cost, plus 2) cost of the purchased items incorporated into the property. Firm quotes based on these criteria are considered a fair retail selling price.

The 1974 amendments to Regulation 1540 also note that tax does not apply to any charge an advertising agency incurs in connection with nontaxable activities on behalf of its clients. This includes fees and commissions for nontaxable activities. However, a general fee added to a billing with both taxable and nontaxable activities is taxable in accordance with the ratio of the taxable and nontaxable charges.

The 1974 amendments did not change the rules governing preliminary art or purchases of supply items that were established in previous versions of the regulation.

Regulation 1540 also had subsequent amendments:

- An amendment in 1976 provided that advertising agencies, artists or designers are consumers of art or photographs used to prepare tangible personal property for resale. If art or photographs are physically incorporated into the work, they may be purchased for resale. Mere use of an image is not physical incorporation.
- An amendment in 1983 clarified the consequences of an agent issuing a resale certificate to a supplier. This amendment states that an agent may not issue a resale certificate to a supplier. If a

FORMAL ISSUE PAPERIssue Paper Number: **99-046**

certificate is issued, it is presumed that the agency is buying on its own behalf for resale and not as an agent.

- An amendment in 1994 detailed the documentation required of commercial artists, designers, or advertising agencies who produce preliminary artwork on data processing equipment. As provided, they must produce a hard copy of claimed preliminary art and retain the copies as part of their books and records.

Analysis

From its amendment as Ruling No. 2, Regulation 1540 has had two constants. First, advertising agencies could act as both agents of their clients and as retailers of tangible personal property. If they were retailers, tax was due on the total amount received from the client. Second, art produced for the purpose of visualization (preliminary art) was nontaxable, but art sold for reproduction or display was subject to tax. Subsequent amendments to the regulation did not change these constants. Rather, the amendments served to define and refine the application of tax to the activities of advertising agencies and commercial artists.

Although the advertising industry has expressed a desire to be treated solely as a service provider, it concurs with the paradigm of agencies acting both as agents and retailers. The advertising industry's primary concern is changing the default status of an agency. The current regulation assumes the default status is that of a retailer. The advertising industry feels that the default status should be that of an agent. Their position is that the prevailing practice within the industry, whether written or not, is for advertising agencies to act as agents of clients. The regulation conflicts with industry practice, which causes difficulties with compliance.

The advertising industry admits that some agencies do act as retailers. However, these agencies adopt retailer status because it is in their business interest to do so for a particular transaction. For example, an agency that acts as a retailer of brochures may be able to make a larger profit because it need not disclose its markup of printing costs. The advertising industry agrees that these advertising agencies are liable for tax on the full selling price of the tangible personal property.

In a related issue, the advertising industry feels that the regulation does not adequately clarify what costs must be included in a retail sale made by advertising agencies. The industry appears to agree that some services should be included as part of a sale, but not nearly as many as asserted by audit staff. The advertising industry explains that services provided to clients have changed over the years. In particular, advertising agencies not only provide advertising materials, but also assist the client in keeping within budget and exercise oversight of products provided by third parties. Terms used for these activities are not defined as exempt in the regulation, which causes problems when advertising agencies are audited.

Both of these issues are addressed by the proposed amendments. First, by presuming a default status as agent, the amended regulation conforms the application of tax to business practice. Second, by expressly defining certain services as exempt, the issue of what services should be included in the sale is clarified. In addition, by providing a formula for advertising agencies to calculate a "taxable selling price," the regulation gives both the advertising industry and staff guidelines on an acceptable reporting method.

Issue Paper Number: **99-046**

Regulation 1540's treatment of artwork has been questioned by both the advertising industry and the graphic arts industry. While there is a general agreement that preliminary art should generally be exempt and certain final art should be taxable, there is a disagreement about the terms used in the regulation to define the process of producing art and about what transfers of art are taxable. In the following paragraphs, these issues are discussed separately.

As noted above, the advertising industry provided information about the effects of computerization on the advertising and graphic arts industries. As both industries pointed out, the use of computers has significantly changed the processes for compiling print advertising and for transmitting it to publishers. In most cases, very little hard copy is produced. Conceptual development, layouts, and preliminary art are produced digitally. Further, camera-ready art is not prepared, nor are negatives or color separations. Rather, the advertising agency will compile various elements of the advertisement in a file on a diskette and transfer the diskette to the printer or publishers. Frequently this file qualifies as exempt digital pre-press instructions. As a result of these technological changes, both industries find the regulation's emphasis on manual processes and its assumption that there is a clear dividing line between creative processes (preliminary art) and final art to be obsolete. One consequence of this disjunction between the regulation and current industry practice is added cost to the industries that results from the need to explain the digital process to Board staff and the excessive record keeping and retrieval required to support claimed exemptions.

Proposed amendments to the regulation conform to the technological changes. In particular, the digital transfer of artwork and finished advertising copy are conformed to the rules governing transfer of computer files that are stated in Regulation 1502. That is, transfers via remote telecommunication are exempt as are transfers made through a download of the files onto the client's computer by the seller. In addition, the advertising industry contends that files transferred to publishers and printers conform to digital pre-press instruction as defined in Regulation 1541. Information supplied by the advertising industry indicates that this contention is correct. Finally, commercial artists and designers are given a bright line for purposes of claiming exempt preliminary art. When a lump-sum charge is made for artwork, 75% of the charge is presumed to be nontaxable conceptual and design services.

The staff and the graphic arts industry did not reach consensus on the application of tax to reproduction rights, that is, the transfer of artwork for reproduction without a corresponding passage of title. Staff's position is that charges for these transfers are taxable. Staff supports this position with references to Revenue and Tax Code sections, regulations, case law, Board decisions, and current litigation. In summary, staff argues that transfers for reproduction constitute a lease that can be considered taxable under Sections 6051, 6201, 6011, 6012, and 6006.3 of the Revenue and Taxation Code. Staff notes that Section 6362, which exempted the one-time use of a photograph, assumed that the transfer was taxable and required a specific exemption. Staff also references the cases of *Capital Records, Inc. v. State Board of Equalization* (1984) 158 Cal.App.3d 582; *Simplicity Pattern Co v. Board of Equalization* (1980) 27 Cal.3d 900, 907; *A&M Records, Inc. v. State Bd. Of Equalization* (1988) 204 Cal.App.3d 358; and *Michael Todd v. County of Los Angeles* (1962) 57 Cal.2d 684. In staff's opinion, all of these cases support the position that the value of intangibles should be included in the total taxable selling price.

Staff also notes that the industry has twice attempted to obtain legislative relief on this issue. To date, the Legislature has not provided this relief.

FORMAL ISSUE PAPERIssue Paper Number: **99-046**

Finally, staff notes that this issue is currently being litigated by the Board in the cases of *Heather Preston* and *Wild Side West*. Staff is of the opinion that any amendments to the basic taxability of reproduction rights should be held until the litigation is resolved.

In response, the graphic arts industry expressed the view that the trend by the Board has been to either 1) allow a total exemption in cases where the value of the tangible personal property is de minimis in comparison to the value of the intangible property transferred, or 2) recognize that two transactions are taking place: a taxable transfer of tangible personal property and a nontaxable sale of intangible property. In such cases, the Board has allocated the charge between taxable and nontaxable components. In support of this view, the graphic arts industry cited Regulations 1502(f)(1)(B), 1529(b)(2)(D)(5) and (d)(16), the treatment of technology transfer agreements in Section 6011(c)(10), and the Board's decision in the *Appeal of Intel Corporation*. Regulation subsection 1502(f)(1)(B) excludes from tax the license fees or royalty payments made for the right to reproduce or copy a program so that the program can be distributed for a consideration to third parties. Regulation subsections 1529(b)(2)(D)(5) and (d)(16) concern the application of tax to "creative art services" provided in connection with the production of a qualified motion picture. Charges and buyout fees for these services are excluded from tax. Section 6011(c)(10) excludes from "sales price" the amount charged for intangible personal property transferred with tangible property in any technology transfer agreement. If the transfer agreement does state a separate price for the tangible personal property, this section provides criteria for establishing a price. The Board decision on *Appeal of Intel Corporation* was the precedent for Section 6011(c)(10).

Staff disagrees that the graphic arts industry's citations indicate a trend. Review of the testimony given in support of the amendments to Regulations 1502 and 1529 show that the respective industries requested the amendments because of unique situations in the industries. The software industry requested the changes to Regulation 1502 because programmers were concerned about paying tax on royalties received on code that was incorporated into canned software programs by a software manufacturer. The industry argued that written code was the equivalent to a manuscript and should be allowed the same exclusion. The movie industry requested the addition of the concept of "creative art services" to Regulation 1529 because it felt that graphic artwork was a qualified production service. The movie industry also asserted that its relationship to artists was different than other industries. The movie industry used graphic artists primarily to provide concepts, designs, or a certain "look" for a production, i.e. preliminary art. Any purchase of the preliminary art was essentially a purchase of the concepts, not the artwork. The preliminary art would be used to develop a promotional campaign and to prevent piracy of concepts. Finally, staff notes that Section 6011(c)(10) was intended by the Legislature to cover only technology transfer agreements and no other type of transactions. The bill enacting this section, AB103, Chap. 887, 1993, states in Section 3 that "the amendments made by this act (do) not create any inference regarding the application of the Sales and Use Tax Law to other transactions involving the transfer of both intangible rights and property and tangible personal property."

Staff and industry agreed that the issue of reproduction rights could not be resolved. As an alternative, staff and industry agreed on the amendments noted on page 6.

Issue Paper Number: **99-046**

V. Staff Recommendation

A. Description of the Staff Recommendation

Staff recommends that Regulation 1540 be amended to reorganize the regulation into a structure which industry finds more usable. The reorganization has separate sections for the advertising industry and commercial artists, lists nontaxable activities first, and then proceeds to taxable activities.

Staff also recommends that Regulation 1540 be amended to incorporate proposed language jointly developed by industry and staff. These amendments would:

- 1) Generally treat advertising agencies as agents,
- 2) Clarify when advertising agencies are retailers,
- 3) Define additional nontaxable services provided by advertising agencies,
- 4) Provide simplified methods for reporting retail sales,
- 5) Clarify when transfers of images on electronic media are nontaxable,
- 6) Allow a rebuttable presumption that 75% of a lump-sum charge that includes both creative and development services and finished artwork is for exempt services,
- 7) Treat as nontaxable any receipt on a reproduction right that is exercised more than one year after the original transfer,
- 8) Require explicit transfer of title or permanent possession for tax to apply to transfers of preliminary art,
- 9) Exclude from tax single copies of blueprints, diagrams, and instructions resulting from environmental graphic design services,
- 10) Exclude from tax charges for designing, editing or hosting an electronic website when no tangible personal property is transferred, and
- 11) Make the regulation consistent with other regulations dealing with transfers or sales of printed matter or artwork.

B. Pros of the Staff Recommendation

- Simplifies the reporting of tax for advertising agencies and graphic artists.
- Makes the regulation consistent with related regulations.
- Conceptually incorporates most of industry's amendments and addresses their concerns.
- Maintains consistency with statutory authority.
- Recognizes the paradigm shift for the advertising and graphic arts industry from manual processes to digital processes.

C. Cons of the Staff Recommendation

- Does not achieve the expressed desire by both industries to be considered solely as service providers.

FORMAL ISSUE PAPERIssue Paper Number: **99-046****D. Statutory or Regulatory Change**

Requires a regulatory amendment.

E. Administrative Impact

Implementation of the recommended amendments is contingent upon approval by the Office of Administrative Law (OAL). In the interim, staff action on in-process audits, disputed audit decisions, and audit selection will be put on hold.

Once OAL approval has been received, implementation will consist of notification to the respective industries and to staff, and staff training. The respective industries will be notified by a special notice. Mailing lists will be obtained from the respective industries. Notification will also be given through a *Taxpayer Information Bulletin* article. Staff will be notified initially by memorandum. This memorandum will be followed up by an *Operations Memo* and updated staff training.

F. Fiscal Impact**1. Cost Impact**

Costs related to amendment of Regulation 1540 are absorbable.

2. Revenue Impact

The only material revenue impact results from the one year limitation for the imposition of tax on receipts for royalties or rights to reproduce. Impact is estimated to less than \$500,000 annually. See Revenue Estimate.

G. Taxpayer/Customer Impact

Will provide additional clarification for those affected.

H. Critical Time Frames

Because the recommended amendments are based on a reinterpretation on existing statutes, there is no operative date. The amendments are retroactive.

VI. Alternative 1**A. Description of the Alternative**

Industry agrees with staff's recommendation, but also proposes that sales of tangible personal property resulting from creative or development services would be nontaxable even if a contract of sale passes title to or permanent possession of the property to the client.

Issue Paper Number: **99-046**

B. Pros of the Alternative

- Exempts all charges associated with creative or development services from tax. Treats the tangible personal property as incidental to the services.

C. Cons of the Alternative

- Is inconsistent with the gross receipts provisions established by statute.
- Results in a revenue loss for the State.

D. Statutory or Regulatory Change

Staff believes that industry's proposal to exempt charges on the transfer of title to or permanent possession of tangible personal property resulting from creative or development services requires a statutory change. All other proposals require amendments to the regulation.

E. Administrative Impact

Minimal impact expected.

F. Fiscal Impact

1. Cost Impact

Related costs are absorbable.

2. Revenue Impact

The revenue impact for exempting tangible personal property resulting from creative or development services is estimated to be less than \$500,000 annually. This would be in addition to the revenue loss resulting from staff's recommendation, since the alternative adopts staff's proposal. See Revenue Estimate.

G. Taxpayer/Customer Impact

Will provide additional clarification for those affected.

H. Critical Time Frames

N/A

FORMAL ISSUE PAPER

Issue Paper Number: **99-046**

Prepared by: Sales and Use Tax Department
Program Planning Division

Current as of: September 20, 1999



REGULATION 1540 – ADVERTISING AGENCIES, COMMERCIAL ARTISTS AND DESIGNERS

Staff Recommendation

Staff recommends that Regulation 1540's provisions related to advertising agencies be amended to: 1) generally treat advertising agencies as agents of their clients, 2) explain under what circumstances advertising agencies are retailers, 3) define additional nontaxable services provided by advertising agencies, 4) provide simplified methods to report retail sales, and 5) make the regulation consistent with other sales and use tax regulations, particularly Regulation 1541, *Printing and Related Arts*.

Staff also recommends that Regulation 1540's provisions related to commercial artists be amended to: 1) clarify when transfers of images on electronic media are nontaxable, 2) allow as nontaxable 75% of a lump-sum billing for creative and development services (currently defined as preliminary art) and finished art, 3) treat as nontaxable any receipts for the sales of additional copyrights or royalties when they are received more than one year after the original transfer of artwork on physical media, 4) require specific passage of title for tax to apply to transfers of tangible personal property produced as a part of creative or development services, 5) exclude from tax transfers of single copies of blueprints, diagrams, and instructions that artists provide to clients as the result of environmental graphic design services, and 6) specifically exclude from tax charges for designing, editing, or hosting an electronic website when no tangible personal property is transferred.

In recognition of technological change, the regulation is proposed to be updated to conform to the industry's use of computer hardware and software to produce print advertising and artwork.

Alternative

The advertising industry proposes that we adopt staff's recommendation except that transfers of tangible personal property resulting from creative or development services would be nontaxable even if a contract of sales passes title or permanent possession of the property to the client.

Background, Methodology, and Assumptions

Staff Recommendation:

The staff recommendation would reorganize Regulation 1540 and add language to clarify which transactions made by advertising agencies and commercial artists and designers are taxable and which are considered to be nontaxable services.

The provision that would treat advertising agencies as agents of their clients would conform the regulation to current practice and therefore, has no revenue impact.

The provision that would allow a rebuttable presumption that 75% of a lump-sum charge that includes both creative and development services and finished artwork is for nontaxable services could result in some changes in taxability on individual transactions. However, since the 75% figure represents a reasonable industry-wide allocation between charges for preliminary and finished art, the overall revenue effect should be negligible.

The one provision that would result in a revenue impact is the provision to treat as nontaxable any receipts for the sales of additional royalties or rights derived from a copyright (e.g. reproduction rights) when they are received more than one year after the original transfer of artwork on physical media. We have no data regarding the total amount of such transactions, but from audit experience in this area, the staff of the Sales and Use Tax Department is of the opinion that the revenue effect of this proposal is limited.

Alternative:

The alternative proposal would treat transfers of tangible personal property resulting from creative or development services (currently defined as preliminary art) as nontaxable, even if a contract of sale passes title or permanent possession of the property to the client.

Neither industry nor the Board has any data on the amount of transactions involving transfer of title or permanent possession of tangible personal property resulting from creative or development services (preliminary art). Normally the delivery of "preliminary art" to a client does not include the transfer of title. In a 1996 discussion of this issue as it applied to the motion picture industry, the motion picture industry estimated that the revenue impact of exempting these types of transactions amounted to \$2.5 million. Based on the belief that these types of transaction are more prevalent in the motion picture industry than in any other industry, it is estimated that exempting these transactions would result in a revenue loss of less than \$500,000.

Revenue Summary

Staff Recommendation:

Based on discussions with program staff, it is estimated that the revenue loss for the staff recommendation would be less than \$500,000.

The effect of staff's recommendation to Regulation 1540 would be retroactive and would create a potential for refunds for 3 years.

Alternative Proposal:

The revenue loss from exempting any charges for the transfer of title or permanent possession of tangible personal property resulting from creative or developmental services (preliminary art) to the client is estimated to be less than \$500,000. This would be in addition to the revenue loss resulting from staff's recommendation, since the alternative adopts staff's proposal.

The effect of industry's proposed amendment to Regulation 1540 would be retroactive and would create a potential for refunds for 3 years.

Preparation

This revenue estimate was prepared by David E. Hayes, Statistics Section, Agency Planning and Research Division. This revenue estimate was reviewed by Ms. Laurie Frost, Chief, Agency Planning and Research Division and Ms. Freda Orendt-Evans, Program Planning Manager, Sales and Use Tax Department. For additional information, please contact Mr. Hayes at (916) 445-0840.

Current as of September 29, 1999

Regulation 1540, Advertising Agencies, Commercial Artists and Designers
Comparison of Current Regulations and Amendments Proposed by Staff and Industry
Current as of 9/20/99

Action Item	Current Regulatory Language	Staff's Proposed Regulatory Language	Industry's Proposed Regulatory Language	Comments on Proposed Amendments
<p>Action 1 – Adopt proposed language agreed upon by staff and industry except for subsection (d)(1).</p>	<p>(a) Advertising Agency as Agent of Client or as Non Agent.</p> <p>(1) General. An agent is one who represents another, called the principal, in dealings with third persons. (Civil Code, Section 2295.) Advertising agencies may act as agents on behalf of their clients in dealing with third persons or they may act on their own behalf. To the extent advertising agencies act as agents of their clients in acquiring tangible personal property they are neither purchasers of the property with respect to the supplier nor sellers of the property with respect to their principals.</p> <p>To the extent advertising agencies act on their own behalf in acquiring tangible personal property they are purchasers of the property with respect to the supplier. Generally, they are sellers of any of the property so acquired which they deliver to, or</p>	<p>(a) Advertising Agencies.</p> <p>(1) General. Advertising agencies provide clients with both services and tangible personal property. Services include, without limit, consultation, consumer research, and media placement. Tangible personal property includes, without limit, video and audio productions, print advertisements, brochures, finished artwork, and other printed matter. When an advertising agency provides services unrelated to the transfer of tangible personal property or when the tangible personal property transferred is incidental to the services, the charges for those services are nontaxable.</p> <p>Application of tax to the sale of tangible personal property and any services related to the sale is dependent on the type of property being sold and the relationship of the advertising agency to the client.</p>	<p>(a) Advertising Agencies.</p> <p>(1) General. Advertising agencies provide clients with both services and tangible personal property. Services include, without limit, consultation, consumer research, and media placement. Tangible personal property includes, without limit, video and audio productions, print advertisements, brochures, finished artwork, and other printed matter. When an advertising agency provides services unrelated to the transfer of tangible personal property or when the tangible personal property transferred is incidental to the services, the charges for those services are nontaxable.</p> <p>Application of tax to the sale of tangible personal property and any services related to the sale is dependent on the type of property being sold and the relationship of the advertising agency to the client.</p>	<p>Subsection (a)(1) defines generally what types of transactions entered into by advertising agencies are subject to sales and use tax. This definition was not provided in the current regulation.</p>

Regulation 1540, Advertising Agencies, Commercial Artists and Designers
Comparison of Current Regulations and Amendments Proposed by Staff and Industry
Current as of 9/20/99

Action Item	Current Regulatory Language	Staff's Proposed Regulatory Language	Industry's Proposed Regulatory Language	Comments on Proposed Amendments
	<p>cause to be delivered to, their clients or to third parties for the benefit of their client. They are also sellers of any of the property which they retain but title to which they transfer to their client.</p> <p>(2) Determination of Status.</p> <p>(A) Items Acquired from Outside Sources. All acquisitions by advertising agencies of tangible personal property such as collateral materials (catalogs, brochures, pamphlets, and the like), artwork (photographs, drawings, paintings, designs, lettering, and the like), and production items (engravings, duplicate plates, mechanicals, assemblies, sound recordings, and the like), are regarded as purchases by the agencies on their own behalf for resale or use unless the agency clearly establishes with respect to any acquisition that it is acting as agent for its client.</p> <p>To establish that a particular</p>	<p>(2) Specific Situations.</p> <p>(A) Electronic or Digital Artwork. Electronic or digital art is the process of using computer software and hardware to compile or compose finished art. Elements of the process include: creation of original artwork or photographs, scanning of artwork or photographs, composition and design of text, insertion and manipulation of scanned and original digital artwork, photographs, or text.</p> <p>A transfer of electronic or digital art from an advertising agency, commercial artist or designer to a client or to a third party on behalf of a client that includes text or images or a combination of both, is not taxable if, (1) the file containing the electronic or digital art is transferred through remote telecommunications, such as a modem, or (2) the file is downloaded on the client's computer by the advertising agency, commercial artist or designer and the</p>	<p>(2) Specific Situations.</p> <p>(A) Electronic or Digital Artwork. Electronic or digital art is the process of using computer software and hardware to compile or compose finished art. Elements of the process include: creation of original artwork or photographs, scanning of artwork or photographs, composition and design of text, insertion and manipulation of scanned and original digital artwork, photographs, or text.</p> <p>A transfer of electronic or digital art from an advertising agency, commercial artist or designer to a client or to a third party on behalf of a client that includes text or images or a combination of both, is not taxable if, (1) the file containing the electronic or digital art is transferred through remote telecommunications, such as a modem, or (2) the file is downloaded on the client's computer by the advertising agency, commercial artist or designer and the</p>	<p>Subsections (a)(2)(A) & (B) detail those types of exempt transactions most common to advertising agencies. Industry noted that most agencies have exempt transactions. It asked that those types of transactions be placed at the beginning of the regulation to allow advertising agencies to more easily determine if any tax was due. Types of sales that are subject to tax are dealt with in subsection (a)(3).</p> <p>Subsection (a)(2)(A) also introduces language pertinent to the current industry practice of using</p>

Regulation 1540, Advertising Agencies, Commercial Artists and Designers
Comparison of Current Regulations and Amendments Proposed by Staff and Industry
Current as of 9/20/99

Action Item	Current Regulatory Language	Staff's Proposed Regulatory Language	Industry's Proposed Regulatory Language	Comments on Proposed Amendments
	<p>acquisition was made as agent for its client (i) the agency must clearly disclose to the supplier the name of the client for whom the agency is acting as agent, (ii) the agency must obtain, prior to the acquisition, and retain written evidence of agent status with the client, and (iii) the price billed to the client, exclusive of any agency fee, must be the same as the amount paid to the supplier. The agency may make no use of the property for its own account, such as charging the item to the account of more than one client. An advertising agency purchasing tangible personal property as an agent on behalf of its client may not issue a resale certificate to the supplier. It will be presumed that an advertising agency who issues a resale certificate to its supplier is purchasing the tangible personal property on its own behalf for resale and is not acting as an agent for its client.</p> <p>The reimbursement for the property should be separately invoiced, or</p>	<p>client does not obtain title to or possession of any tangible personal property, such as a diskette or compact disk. The advertising agency, commercial artist, or designer should document the downloading of electronic artwork in the manner set forth in subsection (d)(2). Transfer of a file qualifying as electronic or digital pre-press instruction as defined by the provisions of Regulation 1541, <i>Printing and Related Arts</i>, is nontaxable.</p> <p>A transfer of title to or possession of a file on electronic media, such as a diskette or compact disc, is subject to tax as stated in subdivision (d)(2).</p> <p>(B) Agency Acting as an Agent for Its Client. An agent is one who represents another, called the principal, in dealings with third persons. (Civil Code, Section 2295.) To the extent an advertising agency acts as an agent of its client in acquiring tangible personal property,</p>	<p>client does not obtain title to or possession of any tangible personal property, such as a diskette or compact disk. The advertising agency, commercial artist, or designer should document the downloading of electronic artwork in the manner set forth in subsection (d)(2). Transfer of a file qualifying as electronic or digital pre-press instruction as defined by the provisions of Regulation 1541, <i>Printing and Related Arts</i>, is nontaxable.</p> <p>A transfer of title to or possession of a file on electronic media, such as a diskette or compact disc, is subject to tax as stated in subdivision (d)(2).</p> <p>(B) Agency Acting as an Agent for Its Client. An agent is one who represents another, called the principal, in dealings with third persons. (Civil Code, Section 2295.) To the extent an advertising agency acts as an agent of its client in acquiring tangible personal property,</p>	<p>computers to generate electronic art.</p> <p>Subsection (a)(2)(B) presumes that an advertising agency is a default agent of its client. It also allows agencies to provide evidence that a resale</p>

Regulation 1540, Advertising Agencies, Commercial Artists and Designers
Comparison of Current Regulations and Amendments Proposed by Staff and Industry
Current as of 9/20/99

Action Item	Current Regulatory Language	Staff's Proposed Regulatory Language	Industry's Proposed Regulatory Language	Comments on Proposed Amendments
	<p>shown separately on an invoice, to the client.</p> <p>(B) Items Prepared by Agency. Advertising agencies are sellers of all items of tangible personal property produced or fabricated by their own employees. Advertising agencies are not agents of their clients with respect to the acquisition of materials incorporated into items of tangible personal property prepared by their employees.</p> <p>(b) Application of Tax to Charges Made by Advertising Agencies.</p> <p>(1) Agency Acting as Seller - Sale of Tangible Personal Property. (See subsection (a)(2) for determination of status.) With respect to billings issued by advertising agencies to clients, some charges may represent the sale price of tangible personal property sold to the client by the agency and compensation for expenses incurred in, and service costs related to, the production of the</p>	<p>it is neither a purchaser of the property with respect to the supplier nor a seller of the property with respect to its principal. Because of the unique relationship between advertising agencies and clients, it is rebuttably presumed that an advertising agency qualifies as an agent when acquiring tangible personal property on behalf of its client. However, an agency is not an agent of its client with respect to tangible personal property fabricated or produced in-house by the agency's own employees and sold to its client.</p> <p>As an agent for its client, sales or use tax is due on the purchase price from the suppliers to the advertising agency. Tax does not apply to the charge made by an advertising agency to its client for reimbursement, including tax reimbursement, charged by a supplier or to charges or fees for an agency's services directly related to such acquisitions of tangible personal property.</p>	<p>it is neither a purchaser of the property with respect to the supplier nor a seller of the property with respect to its principal. Because of the unique relationship between advertising agencies and clients, it is rebuttably presumed that an advertising agency qualifies as an agent when acquiring tangible personal property on behalf of its client. However, an agency is not an agent of its client with respect to tangible personal property fabricated or produced in-house by the agency's own employees and sold to its client.</p> <p>As an agent for its client, sales or use tax is due on the purchase price from the suppliers to the advertising agency. Tax does not apply to the charge made by an advertising agency to its client for reimbursement, including tax reimbursement, charged by a supplier or to charges or fees for an agency's services directly related to such acquisitions of tangible personal property.</p>	<p>certificate was issued in error when acting in the capacity of an agent.</p>

Regulation 1540, Advertising Agencies, Commercial Artists and Designers
Comparison of Current Regulations and Amendments Proposed by Staff and Industry
Current as of 9/20/99

Action Item	Current Regulatory Language	Staff's Proposed Regulatory Language	Industry's Proposed Regulatory Language	Comments on Proposed Amendments
	<p>property. Tax applies to the total amount of the retail sale of the property. Tax applies whether the property was prepared by employees of the agency or acquired from an outside source. Whether the items of property are used for reproduction or display purposes is immaterial.</p> <p>Tax applies to all charges made for such property, including charges for copy written solely for use as a part of such property. Tax applies to charges for services rendered that represent services that are a part of a sale of the property, or a labor or service cost in the production of the property. Charges for such items as supervision, consultation, research, postage, express, telephone and telegraph messages, and travel expense, if involved in the rendering of such services, are likewise taxable. No deduction may be taken on account of the payment of model fees or talent fees, or for the cost of typography, or for the cost of other services involved in the producing of</p>	<p>An advertising agency may not issue a resale certificate when making purchases as an agent. It will be presumed that an advertising agency who issues a resale certificate to a supplier is purchasing tangible personal property on its own behalf for resale and is not acting as an agent for its client. However, the advertising agency may provide evidence to prove that the presentation of the resale certificate was erroneous and that the advertising agency was acting as an agent of its client. If the resale certificate was issued in error, the advertising agency is liable for use tax on the cost of tangible personal property purchased under the certificate unless, 1. The agency has already paid tax to the supplier or to the Board, or 2. The client has self-reported the tax.</p> <p>(3) Advertising Agencies Acting as Retailers</p>	<p>An advertising agency may not issue a resale certificate when making purchases as an agent. It will be presumed that an advertising agency who issues a resale certificate to a supplier is purchasing tangible personal property on its own behalf for resale and is not acting as an agent for its client. However, the advertising agency may provide evidence to prove that the presentation of the resale certificate was erroneous and that the advertising agency was acting as an agent of its client. If the resale certificate was issued in error, the advertising agency is liable for use tax on the cost of tangible personal property purchased under the certificate unless, 1. The agency has already paid tax to the supplier or to the Board, or 2. The client has self-reported the tax.</p> <p>(3) Advertising Agencies Acting as Retailers</p>	<p>Subsection (a)(3)</p>

Regulation 1540, Advertising Agencies, Commercial Artists and Designers
Comparison of Current Regulations and Amendments Proposed by Staff and Industry
Current as of 9/20/99

Action Item	Current Regulatory Language	Staff's Proposed Regulatory Language	Industry's Proposed Regulatory Language	Comments on Proposed Amendments
	<p>such items, even though such costs are itemized in the billing rendered to the client.</p> <p>If an agency supplies tangible personal property such as finished artwork to a client and the entire payment for such property is included in some other form of compensation such as a fee, commissions or a combination thereof, tax applies to the fair retail selling price of such property.</p> <p>"Fair retail selling price" is an amount sufficient to cover (i) the net labor costs of employees of the agency plus an allowance for overhead and profit of not less than 100 percent of such labor cost, and (ii) the cost of purchased items incorporated into the tangible personal property as to which the agency is a seller. If an agency has furnished a firm quoted price based on estimated labor costs plus overhead and profit of not less than 100 percent of the labor cost and</p>	<p>(A) Election of Non-Agent Status. An advertising agency may elect non-agent status with respect to sales to its client. This election must be supported by a specific written statement in its contract or agreement with the client. Alternatively, a statement may be included on an agency's invoice to its client. Statements should include the following or similar language: "(Agency name) does not qualify as an agent of (client name) for purposes of this transaction."</p> <p>An agency that elects non-agent status is a retailer with respect to tangible personal property sold to its clients. The agency may issue a resale certificate to its suppliers for tangible personal property that it is planning to resell to clients or to incorporate into property that will be sold to clients.</p> <p>The taxable selling price is the separately stated charge for the tangible personal property. If there</p>	<p>(A) Election of Non-Agent Status. An advertising agency may elect non-agent status with respect to sales to its client. This election must be supported by a specific written statement in its contract or agreement with the client. Alternatively, a statement may be included on an agency's invoice to its client. Statements should include the following or similar language: "(Agency name) does not qualify as an agent of (client name) for purposes of this transaction."</p> <p>An agency that elects non-agent status is a retailer with respect to tangible personal property sold to its clients. The agency may issue a resale certificate to its suppliers for tangible personal property that it is planning to resell to clients or to incorporate into property that will be sold to clients.</p> <p>The taxable selling price is the separately stated charge for the tangible personal property. If there</p>	<p>defines when advertising agencies qualify as retailers. Agencies may elect to be non-agents, or they may overcome the presumption of agency when making sales of tangible personal property for a lump-sum price.</p>

Regulation 1540, Advertising Agencies, Commercial Artists and Designers
Comparison of Current Regulations and Amendments Proposed by Staff and Industry
Current as of 9/20/99

Action Item	Current Regulatory Language	Staff's Proposed Regulatory Language	Industry's Proposed Regulatory Language	Comments on Proposed Amendments
	<p>bills in accordance with such a quoted price, the agency will be deemed to have charged a fair retail selling price.</p> <p>(2) Agency Acting as Agent - Reimbursement for Property Acquired as Agent. (See subsection (a)(2) for determination of status.) Some charges may represent reimbursement for tangible personal property acquired by the agency as agent for its client and compensation for the performance of agency services related thereto.</p> <p>When an advertising agency establishes that it has acquired tangible personal property as agent for its client, tax does not apply to the charge made by the agency to its client for reimbursement including tax reimbursement charged by a supplier or to the charge made for the performance of the agency's services directly related to such acquisitions of personal property.</p>	<p>is no separately stated charge, the taxable selling price may be calculated as shown in subdivision (b).</p> <p>(B) Items Produced or Fabricated by an Agency In-house. Advertising agencies are retailers of tangible personal property produced or fabricated by their own employees. Advertising agencies are not agents of their clients with respect to the acquisition of materials incorporated into items of tangible personal property prepared by their employees. However, in the case of intermediate production or printing aids used by the agency's employees to fabricate tangible personal property, it will be presumed that an advertising agency passes title to the aids to the client prior to use by the agency and the measure of tax will be computed in the same manner as provided in Regulation 1541 for special printing aids. Intermediate production or printing aids include, but are not limited to, artwork,</p>	<p>is no separately stated charge, the taxable selling price may be calculated as shown in subdivision (b).</p> <p>(B) Items Produced or Fabricated by an Agency In-house. Advertising agencies are retailers of tangible personal property produced or fabricated by their own employees. Advertising agencies are not agents of their clients with respect to the acquisition of materials incorporated into items of tangible personal property prepared by their employees. However, in the case of intermediate production or printing aids used by the agency's employees to fabricate tangible personal property, it will be presumed that an advertising agency passes title to the aids to the client prior to use by the agency and the measure of tax will be computed in the same manner as provided in Regulation 1541 for special printing aids. Intermediate production or printing aids include, but are not limited to, artwork,</p>	<p>Subsection (a)(3)(B) provides that agencies are always retailers when they are selling tangible personal property fabricated in-house by employees.</p>

Regulation 1540, Advertising Agencies, Commercial Artists and Designers
Comparison of Current Regulations and Amendments Proposed by Staff and Industry
Current as of 9/20/99

Action Item	Current Regulatory Language	Staff's Proposed Regulatory Language	Industry's Proposed Regulatory Language	Comments on Proposed Amendments
	<p>(3) Services and Expenses - When Nontaxable. Some charges may represent the price for the performance of services rendered that do not represent services that are a part of a sale of tangible personal property, or a labor or service cost in the production of such property. Tax does not apply to charges for services rendered that do not represent services that are a part of a sale of tangible personal property, or a labor or service cost in the production of tangible personal property. Charges for such items as supervision, consultation, research, postage, express, telephone and telegraph messages, and travel expense, if involved in the rendering of such services, are likewise nontaxable.</p> <p>(4) Specific Applications.</p> <p>(A) Preliminary Art. "Preliminary art" means roughs, visualizations, layouts and comprehensives, title to which does</p>	<p>illustrations, photography, photo engravings, and other similar materials.</p> <p>Except for artwork, tax is due on the taxable selling price of tangible personal property fabricated or produced by the agency's employees. Artwork shall be taxed in the manner set forth in subsection (b)(1) or (d)(1). An advertising agency should issue a resale certificate for items that become an ingredient or component part of such tangible personal property and for intermediate production or printing aids. The term "ingredient or component part of other tangible personal property" includes only those items that become physically incorporated into the property and not those which are merely consumed or used in the production of the property sold.</p> <p>(b) Lump-sum Sales of Tangible Personal Property.</p>	<p>illustrations, photography, photo engravings, and other similar materials.</p> <p>Except for artwork, tax is due on the taxable selling price of tangible personal property fabricated or produced by the agency's employees. Artwork shall be taxed in the manner set forth in subsection (b)(1) or (d)(1). An advertising agency should issue a resale certificate for items that become an ingredient or component part of such tangible personal property and for intermediate production or printing aids. The term "ingredient or component part of other tangible personal property" includes only those items that become physically incorporated into the property and not those which are merely consumed or used in the production of the property sold.</p> <p>(b) Lump-sum Sales of Tangible Personal Property.</p>	

Regulation 1540, Advertising Agencies, Commercial Artists and Designers
Comparison of Current Regulations and Amendments Proposed by Staff and Industry
Current as of 9/20/99

Action Item	Current Regulatory Language	Staff's Proposed Regulatory Language	Industry's Proposed Regulatory Language	Comments on Proposed Amendments
	<p>not pass to the client but which is prepared by an advertising agency, commercial artist or designer solely for the purpose of demonstrating an idea or message for acceptance by the client before a contract is entered into or before approval is given for preparation of finished art to be furnished by the agency, commercial artist or designer to its client. Tax does not apply to separate charges for preliminary art except where the preliminary art becomes physically incorporated into the finished art, as, for example, when the finished art is made by inking directly over a pencil sketch or drawing, or the approved layout is used as camera copy for reproduction. If the preliminary art is prepared on data processing equipment, the advertising agency, commercial artist, or designer shall produce a hard copy of each of the roughs, visualizations, layouts or comprehensives presented for client approval and retain such copies in accordance with subdivision (d) of Regulation 1698.</p>	<p>(1) An agency that has a contract or agreement to sell tangible personal property for a lump-sum amount is a retailer of the tangible personal property and tax applies to the lump-sum selling price, except for artwork. An advertising agency, commercial artist or designer making a lump-sum sale of tangible personal property to a client may issue a resale certificate to a supplier.</p> <p>On sales of artwork for which an advertising agency, commercial artist or designer makes a lump-sum charge that includes both the nontaxable services defined in subsection (d)(1) and finished art, it will be rebuttably presumed that 75% of the lump-sum charge is for the nontaxable services.</p> <p>(2) Taxable Selling Price. If advertising agencies, commercial artists or designers combine charges for nontaxable services, such as media placement, with the charges for tangible personal property of</p>	<p>(1) An agency that has a contract or agreement to sell tangible personal property for a lump-sum amount is a retailer of the tangible personal property and tax applies to the lump-sum selling price, except for artwork. An advertising agency, commercial artist or designer making a lump-sum sale of tangible personal property to a client may issue a resale certificate to a supplier.</p> <p>On sales of artwork for which an advertising agency, commercial artist or designer makes a lump-sum charge that includes both the nontaxable services defined in subsection (d)(1) and finished art, it will be rebuttably presumed that 75% of the lump-sum charge is for the nontaxable services.</p> <p>(2) Taxable Selling Price. If advertising agencies, commercial artists or designers combine charges for nontaxable services, such as media placement, with the charges for tangible personal property of</p>	<p>Subsection (b) simplifies the methods for reporting taxable sales. Methods include using a calculated selling price which includes cost of materials, direct labor and a reasonable markup, and allowing for a set percentage to be excluded for creative and development services when reporting a lump-sum selling price for artwork.</p> <p>This subsection also defines those services specifically excluded from tax and provides references to other regulations that govern transactions of advertising agencies.</p>

Regulation 1540, Advertising Agencies, Commercial Artists and Designers
Comparison of Current Regulations and Amendments Proposed by Staff and Industry
Current as of 9/20/99

Action Item	Current Regulatory Language	Staff's Proposed Regulatory Language	Industry's Proposed Regulatory Language	Comments on Proposed Amendments
	<p>The charge for preliminary art must be billed separately to the client, either on a separate billing or separately charged for on the billing for the finished art. It must be clearly identified on the billing as preliminary art. Proof of ordering or producing the preliminary art, prior to the date of the contract or approval for finished art, shall be evidenced by purchase orders of the buyer, or by work orders or other records of the agency, commercial artist or designer. No other proof shall be required.</p> <p>(B) Finished Art. "Finished art" means the final art used for actual reproduction by photo-mechanical or other processes; or for display purposes including charts, graphs, and illustrative materials not reproduced. Tax applies to the total charges made by advertising agencies, commercial artists or designers to their clients for finished art produced by them.</p>	<p>which the agencies, artists or designers are the retailers, they shall report a "taxable selling price" for the tangible personal property that includes the total of: 1. direct labor, 2. the cost of purchased items that become an ingredient or component part of the tangible personal property and the cost of any intermediate production or printing aids, and 3. a reasonable markup. The advertising agency, commercial artist or designer must keep sufficient records to document the basis for the reported taxable selling price.</p> <p>(3) Specific Nontaxable Charges. The following and similar fees, commission, and services are nontaxable if separately stated. If not separately stated, these charges are not considered direct labor when calculating a taxable selling price as defined in subdivision (b).</p> <p>(A) Agent fees added to purchases of tangible personal property by agencies established as agents for</p>	<p>which the agencies, artists or designers are the retailers, they shall report a "taxable selling price" for the tangible personal property that includes the total of: 1. direct labor, 2. the cost of purchased items that become an ingredient or component part of the tangible personal property and the cost of any intermediate production or printing aids, and 3. a reasonable markup. The advertising agency, commercial artist or designer must keep sufficient records to document the basis for the reported taxable selling price.</p> <p>(3) Specific Nontaxable Charges. The following and similar fees, commission, and services are nontaxable if separately stated. If not separately stated, these charges are not considered direct labor when calculating a taxable selling price as defined in subdivision (b).</p> <p>(A) Agent fees added to purchases of tangible personal property by agencies established as agents for</p>	

Regulation 1540, Advertising Agencies, Commercial Artists and Designers
Comparison of Current Regulations and Amendments Proposed by Staff and Industry
Current as of 9/20/99

Action Item	Current Regulatory Language	Staff's Proposed Regulatory Language	Industry's Proposed Regulatory Language	Comments on Proposed Amendments
	<p>(C) Consultation and Research. Tax applies to charges for consultation and research if the consultation or research relates solely to tangible personal property as to which the agency is acting as a seller. Tax does not apply to such charges in other circumstances, including those in which the agency is acting as agent, or where research charges relate to advertising testing even though the agency may have been the seller of tangible personal property used in conveying the advertising message.</p> <p>(D) Supervision. Tax applies to charges for supervision if the supervision relates directly and solely to tangible personal property as to which the agency is acting as a seller, for example, supervision of an art department engaged in the production of tangible personal property sold to a client. Tax does not apply when the agency is acting as agent or when charges for supervision do not relate</p>	<p>their clients as compensation for their performances of services related to such purchases.</p> <p>(B) Media commissions derived by agencies for placement of advertising whether paid by the medium, by another agency, or by the client. The service of placing of advertising is not a service that is a part of a sale of tangible personal property.</p> <p>(C) Commissions paid to agencies by suppliers. Examples of such commissions are those paid to an agency by a premium manufacturer (or distributor) or a direct-by-mail supplier.</p> <p>(D) Consultation and concept development fees related to client discussion, development of ideas and other services. Tangible personal property produced as a result of these services is incidental to the service and nontaxable.</p> <p>(E) Research or account planning</p>	<p>their clients as compensation for their performances of services related to such purchases.</p> <p>(B) Media commissions derived by agencies for placement of advertising whether paid by the medium, by another agency, or by the client. The service of placing of advertising is not a service that is a part of a sale of tangible personal property.</p> <p>(C) Commissions paid to agencies by suppliers. Examples of such commissions are those paid to an agency by a premium manufacturer (or distributor) or a direct-by-mail supplier.</p> <p>(D) Consultation and concept development fees related to client discussion, development of ideas and other services. Tangible personal property produced as a result of these services is incidental to the service and nontaxable.</p> <p>(E) Research or account planning</p>	

Regulation 1540, Advertising Agencies, Commercial Artists and Designers
Comparison of Current Regulations and Amendments Proposed by Staff and Industry
Current as of 9/20/99

Action Item	Current Regulatory Language	Staff's Proposed Regulatory Language	Industry's Proposed Regulatory Language	Comments on Proposed Amendments
	<p>solely to tangible personal property.</p> <p>(E) Copy Writing. Tax applies to charges for writing copy written solely for use as a part of tangible personal property as to which the agency is acting as a seller. Tax does not apply to such charges in other circumstances or when the agency is acting as agent.</p> <p>Tax does not apply where copy is furnished to media in manuscript form.</p> <p>(F) Typography Charges, Model Fees, Talent Fees. Tax applies to charges for typography, model fees (including reuse payments), and talent fees (including residual payments), made by agencies to their clients when such fees are part of the charge for tangible personal property sold by the agency. Tax does not apply to such charges or fees when the agency acts as agent.</p>	<p>that entail consumer research and the application of that research to the client's business or industry.</p> <p>(F) Quality control supervision that entails the proofing and review of printing and other products provided by outside vendors.</p> <p>(G) Separately stated charges for the formulation and writing of copy.</p> <p>(4) Taxable Charges for Agencies Acting as Retailers. All other commissions, fees or services exclusively related to the production or fabrication of tangible personal property are taxable and are considered part of direct labor. Such charges include retouching of photographs or other artwork for reproduction, provided the retouching is intended to improve the quality of the reproduction. Retouching for the purpose of repairing or restoring a photograph to its original condition is not taxable.</p>	<p>that entail consumer research and the application of that research to the client's business or industry.</p> <p>(F) Quality control supervision that entails the proofing and review of printing and other products provided by outside vendors.</p> <p>(G) Separately stated charges for the formulation and writing of copy.</p> <p>(4) Taxable Charges for Agencies Acting as Retailers. All other commissions, fees or services exclusively related to the production or fabrication of tangible personal property are taxable and are considered part of direct labor. Such charges include retouching of photographs or other artwork for reproduction, provided the retouching is intended to improve the quality of the reproduction. Retouching for the purpose of repairing or restoring a photograph to its original condition is not taxable.</p>	

Regulation 1540, Advertising Agencies, Commercial Artists and Designers
Comparison of Current Regulations and Amendments Proposed by Staff and Industry
Current as of 9/20/99

Action Item	Current Regulatory Language	Staff's Proposed Regulatory Language	Industry's Proposed Regulatory Language	Comments on Proposed Amendments
	<p>(G) Motion Picture Productions. Tax applies to motion picture productions, including those for television, in the manner set forth in Regulation 1529, "Motion Pictures".</p> <p>(H) Purchase Agent Fees. Fees added to purchases of tangible personal property by agencies established as agents for their clients as compensation for their performances of services related to such purchases are not taxable.</p> <p>(I) Media Commissions. Commissions derived by agencies for placement of advertising are not taxable whether paid by the medium, by another agency, or by the client. The service of placing of advertising is not a service that is a part of a sale of tangible personal property.</p> <p>(J) Supplier Commissions. Commissions paid to agencies by suppliers are not taxable receipts of the agencies. Examples of such nontaxable commissions would be</p>	<p>(5) Charges and Transactions Governed by Other Regulations.</p> <p>(A) Video or Film Productions. If video or film productions provided by an advertising agency to clients are qualified production services, the application of tax is determined by Regulation 1529, <i>Motion Pictures</i>.</p> <p>(B) Audio Productions. An audio production provided by an advertising agency to a client falls under the provisions of Regulation 1527, <i>Sound Recording</i>. Tax will apply as defined by that regulation.</p> <p>(C) Typography. Tax applies to charges for typography or composed type obtained from outside vendors as provided in Regulation 1541, <i>Printing and Related Arts</i>.</p> <p>(c) Commercial Artists and Designers</p>	<p>(5) Charges and Transactions Governed by Other Regulations.</p> <p>(A) Video or Film Productions. If video or film productions provided by an advertising agency to clients are qualified production services, the application of tax is determined by Regulation 1529, <i>Motion Pictures</i>.</p> <p>(B) Audio Productions. An audio production provided by an advertising agency to a client falls under the provisions of Regulation 1527, <i>Sound Recording</i>. Tax will apply as defined by that regulation.</p> <p>(C) Typography. Tax applies to charges for typography or composed type obtained from outside vendors as provided in Regulation 1541, <i>Printing and Related Arts</i>.</p> <p>(c) Commercial Artists and Designers</p>	

Regulation 1540, Advertising Agencies, Commercial Artists and Designers
Comparison of Current Regulations and Amendments Proposed by Staff and Industry
Current as of 9/20/99

Action Item	Current Regulatory Language	Staff's Proposed Regulatory Language	Industry's Proposed Regulatory Language	Comments on Proposed Amendments
	<p>commissions paid to an agency by a premium manufacturer (or distributor) or a direct-by-mail supplier.</p> <p>(K) Fee Added to a Total Billing. The term "fee" as used herein means a general over-all fee encompassing all agency services performed for the client. Such fees may be fixed or based on agency costs and are generally in lieu of commissions, fees added to purchases, and separate time charges added to jobs or agency projects or any combination thereof.</p> <p>A fee added by an agency to a total billing encompassing items as to which the agency is a seller and items as to which tax does not apply is taxable in accordance with the ratio between the charges for the items as to which the agency is a seller and the charges for nontaxable items if the agency performed no duties as an agent of its client, within the standards set forth in (a)(2)(A), during the course of its performance</p>	<p>General. Commercial artists and designers provide services, electronic artwork, and tangible personal property to their clients. Services include, but are not limited to, the creation and development of ideas, concepts, looks, or messages. Electronic artwork can be transferred either through remote telecommunications, such as a modem, or by electronic media such as diskettes or compact disks. Tangible personal property includes both electronic media on which electronic artwork is transferred to the client and hard copies of the electronic artwork, or manually created art. "Finished art" means the final art used for actual reproduction by photomechanical or other processes, or used for display. It includes, but is not limited to, electronic art, illustrations (e.g. drawings, diagrams, halftones, or color images), photographs, paintings, and handlettering. Blueprints, diagrams, and instructions for signage furnished to</p>	<p>General. Commercial artists and designers provide services, electronic artwork, and tangible personal property to their clients. Services include, but are not limited to, the creation and development of ideas, concepts, looks, or messages. Electronic artwork can be transferred either through remote telecommunications, such as a modem, or by electronic media such as diskettes or compact disks. Tangible personal property includes both electronic media on which electronic artwork is transferred to the client and hard copies of the electronic artwork, or manually created art. "Finished art" means the final art used for actual reproduction by photomechanical or other processes, or used for display. It includes, but is not limited to, electronic art, illustrations (e.g. drawings, diagrams, halftones, or color images), photographs, paintings, and handlettering. Blueprints, diagrams, and instructions for signage furnished to</p>	<p>Subsection (c) defines generally what types of transactions entered into by commercial artists and designers may be subject to sales and use tax and the circumstances under which they are taxable.</p>

Regulation 1540, Advertising Agencies, Commercial Artists and Designers
Comparison of Current Regulations and Amendments Proposed by Staff and Industry
Current as of 9/20/99

Action Item	Current Regulatory Language	Staff's Proposed Regulatory Language	Industry's Proposed Regulatory Language	Comments on Proposed Amendments
<p>Action 2 - Applying tax to</p>	<p>under the contract with its client.</p> <p>A fee added to a total billing encompassing taxable and nontaxable elements is not taxable if the agency has acted as agent for its client with respect to the acquisition of tangible personal property acquired for the client from outside sources, provided the taxable items are billed at their fair retail selling price.</p> <p>If an agency which has acted as agent of its client fails to bill the items as to which it is a retailer at their fair retail selling price, as defined in (b)(1) above, the fee added to the billing is taxable in accordance with the ratio between the taxable and nontaxable charges.</p> <p>(L) Retouching. Retouching ordinarily constitutes a step in the process of preparing photographs or other artwork for reproduction, and is done to improve the quality of the reproductions. Tax applies to</p>	<p>a client as the result of environmental graphic design services are not "finished art."</p> <p>An advertising agency that provides creative or development services for the sole purpose of furnishing finished art to their clients is subject to tax as provided in subsection (d).</p> <p>(d) Application of Tax to Commercial Artists and Designers</p> <p>(1) Services. Services performed to convey ideas, concepts, looks or messages to a client may result in a transfer, enhancement or revision of either electronic artwork, hard copies of electronic artwork, or copies of manually prepared artwork. If charges for such services are separately stated as "design charges," "preliminary art," "concept development," or any other designation that clearly indicates that the charges are for such services and not for finished art, they are nontaxable unless the contract of</p>	<p>a client as the result of environmental graphic design services are not "finished art."</p> <p>An advertising agency that provides creative or development services for the sole purpose of furnishing finished art to their clients is subject to tax as provided in subsection (d).</p> <p>(d) Application of Tax to Commercial Artists and Designers</p> <p>(1) Services. Services performed to convey ideas, concepts, looks or messages to a client may result in a transfer, enhancement or revision of either electronic artwork, hard copies of electronic artwork, or copies of manually prepared artwork. If charges for such services are separately stated as "design charges," "preliminary art," "concept development," or any other designation that clearly indicates that the charges are for such services and not for finished art, they are nontaxable.</p>	<p>Subsection (d) details the application of tax to various products and services provided by commercial artists and designers. It defines exempt services as being those used to convey</p>

Regulation 1540, Advertising Agencies, Commercial Artists and Designers
Comparison of Current Regulations and Amendments Proposed by Staff and Industry
Current as of 9/20/99

Action Item	Current Regulatory Language	Staff's Proposed Regulatory Language	Industry's Proposed Regulatory Language	Comments on Proposed Amendments
transfers of tangible personal property resulting from services even if title or permanent possession is passed by contract	<p>charges for photo retouching unless it can be clearly demonstrated that the retouching is done only for the purpose of repairing or restoring a photograph to its original condition.</p> <p>(c) Commercial Artists and Designers. The tax applies to the entire amount charged by commercial artists or designers for items of tangible personal property such a drawings, paintings, designs or sketches transferred to the client, whether or not the property is suitable for display or is useful for actual reproduction by photo-mechanical or other processes.</p> <p>Tax does not apply to separate charges for preliminary art as defined in (b)(4)(A).</p>	<p>sale provides that the commercial artist or designer will pass to the client title or the right to permanent possession of the electronic media or hard copy.</p> <p>A commercial artist or designer who provides nontaxable services is the consumer of tangible personal property used in the performance of such services and tax applies to the sale of property to the commercial artist or designer.</p>	<p>A commercial artist or designer who provides nontaxable services is the consumer of tangible personal property used in the performance of such services and tax applies to the sale of property to the commercial artist or designer.</p>	<p>ideas, concepts, looks or messages. Separately stated charges for such services are exempt unless the artist or designer passes the client title or permanent possession of the electric media by contract.</p> <p>Industry's position is that sales of hard copy or electronic media resulting from these services should not be taxable, even if a contract of sale passes title to or permanent possession of the property.</p>
Action 1 - Adopt proposed language agreed	<p>(d) Items Purchased by Agency or by Artist or Designer. An advertising agency, artist, or designer is the consumer of tangible personal property used in the operation of its business. Such property may include</p>	<p>(2) Electronic Artwork and Finished Art. A transfer of electronic artwork from a commercial artist or designer to a customer or to a third party on behalf of the customer is not taxable if the file containing the electronic artwork is transferred through remote telecommunications, or if the file is loaded on the customer's computer by the commercial artist or designer, and the customer does not obtain title to or possession of any tangible personal property, such as electronic media. The graphic artist should</p>	<p>(2) Electronic Artwork and Finished Art. A transfer of electronic artwork from a commercial artist or designer to a customer or to a third party on behalf of the customer is not taxable if the file containing the electronic artwork is transferred through remote telecommunications, or if the file is loaded on the customer's computer by the commercial artist or designer, and the customer does not obtain title to or possession of any tangible personal property, such as electronic media. The graphic artist should</p>	<p>Subsection (d)(2) defines when tax applies to charges for electronic and other artwork. It provides a</p>

Regulation 1540, Advertising Agencies, Commercial Artists and Designers
Comparison of Current Regulations and Amendments Proposed by Staff and Industry
Current as of 9/20/99

Action Item	Current Regulatory Language	Staff's Proposed Regulatory Language	Industry's Proposed Regulatory Language	Comments on Proposed Amendments
upon by staff and industry except for subsection (d)(1).	<p>stationery, ink, paint, tools, drawing tables, T-squares, pens, pencils, and other office supplies. Tax applies to the sale of such property to the agency, artist, or designer.</p> <p>The agency, artist, or designer is the seller of, and may purchase for resale, any tangible personal property that it resells before use, or that becomes physically an ingredient or component part of tangible personal property sold by it prior to use. Such property may include illustration board, paint, ink, rubber cement, flap paper, wrapping paper.</p> <p>An advertising agency, artist, or designer is the consumer of property such as photographs and art which it uses in the preparation of tangible personal property as to which it is acting as a seller unless, prior to any use having been made of the property, the property is sold or becomes an ingredient or component part of other tangible personal property sold. The agency, artist, or</p>	<p>document his or her transfer and loading of electronic artwork on the client's computer by a statement on the invoice or contract with the following language: "This electronic artwork was loaded onto my computer by (graphic artist's or seller's name). No electronic media, such as diskettes or compact disks, or hardcopies containing the artwork were transferred to me." This statement should be signed or initialed by the client. When such a statement is timely completed, it will be rebuttably presumed that the transfer of electronic artwork is nontaxable. To be timely completed, the statement must be initialed or signed at the time the file is loaded or at the point the transfer is invoiced to the client. In lieu of the statement, the commercial artist or designer may provide other substantive evidence indicating that the artwork was transferred in an exempt manner.</p> <p>The electronic or manual preparation</p>	<p>document his or her transfer and loading of electronic artwork on the client's computer by a statement on the invoice or contract with the following language: "This electronic artwork was loaded onto my computer by (graphic artist's or seller's name). No electronic media, such as diskettes or compact disks, or hardcopies containing the artwork were transferred to me." This statement should be signed or initialed by the client. When such a statement is timely completed, it will be rebuttably presumed that the transfer of electronic artwork is nontaxable. To be timely completed, the statement must be initialed or signed at the time the file is loaded or at the point the transfer is invoiced to the client. In lieu of the statement, the commercial artist or designer may provide other substantive evidence indicating that the artwork was transferred in an exempt manner.</p> <p>The electronic or manual preparation</p>	<p>means for supporting an exempt transfer when a file on a diskette is delivered and loaded by the seller. It also presumes that 75% of lump-sum charges for artwork are for exempt services.</p>

Regulation 1540, Advertising Agencies, Commercial Artists and Designers
Comparison of Current Regulations and Amendments Proposed by Staff and Industry
Current as of 9/20/99

Action Item	Current Regulatory Language	Staff's Proposed Regulatory Language	Industry's Proposed Regulatory Language	Comments on Proposed Amendments
	<p>designer may purchase for resale photographs and art which, prior to any use, are sold or become physically an ingredient or component part of other tangible personal property that is sold by the agency, artist, or designer.</p> <p>The term "ingredient or component part of other tangible personal property" includes only those items that become physically incorporated into the property sold and not those which are merely consumed or used in the production of the property sold. A photograph, for example, does not become an ingredient or component part of property sold merely because the image of the photograph is reproduced as part of the property sold. A photograph or art is regarded as having been used when a reproduction is made from the photograph or art.</p>	<p>of finished art for use in reproduction or display is not a service. Unless transferred or installed in the manner set forth in the preceding paragraph, tax applies to all charges for finished art, including to all charges for any rights, as provided in subdivision (d)(4), sold with the finished art, such as, without limitation, copyrights or distribution and production rights. If charges for finished art are combined with nontaxable services described in subdivision (d)(1), tax may be reported on a calculated selling price, as defined in subsection (b2) provided the retail selling price also includes the value of rights as provided in subdivision (d)(4). In lieu of using a calculated selling price, commercial artists and designers may use the method described in (b)(1), that is, it will be rebuttably presumed that 75% of a combined charge is for the nontaxable services.</p> <p>If the commercial artist or designer</p>	<p>of finished art for use in reproduction or display is not a service. Unless transferred or installed in the manner set forth in the preceding paragraph, tax applies to all charges for finished art, including to all charges for any rights, as provided in subdivision (d)(4), sold with the finished art, such as, without limitation, copyrights or distribution and production rights. If charges for finished art are combined with nontaxable services described in subdivision (d)(1), tax may be reported on a calculated selling price, as defined in subsection (b2) provided the retail selling price also includes the value of rights as provided in subdivision (d)(4). In lieu of using a calculated selling price, commercial artists and designers may use the method described in (b)(1), that is, it will be rebuttably presumed that 75% of a combined charge is for the nontaxable services.</p> <p>If the commercial artist or designer</p>	

Regulation 1540, Advertising Agencies, Commercial Artists and Designers
Comparison of Current Regulations and Amendments Proposed by Staff and Industry
Current as of 9/20/99

Action Item	Current Regulatory Language	Staff's Proposed Regulatory Language	Industry's Proposed Regulatory Language	Comments on Proposed Amendments
		<p>uses any intermediate production or printing aids in the creation of the finished art, it will be presumed that title to the aids was passed to the client prior to use by the commercial artist or designer. The measure of tax for these aids will be computed in the same manner as provided by Regulation 1541 for special printing aids. Intermediate production or printing aids include, but are not limited to, artwork, illustrations, photography, photo engravings, and other similar materials.</p> <p>(3) Signage. Tax does not apply to the services to create single copies of blueprints, diagrams, and instructions for signage provided as a result of environmental graphic design. Reproduction charges for additional copies are taxable.</p> <p>(4) Reproduction Rights. Charges for the transfer by a tangible medium of a photograph or of finished art for purposes of reproduction are taxable even though there is no transfer of</p>	<p>uses any intermediate production or printing aids in the creation of the finished art, it will be presumed that title to the aids was passed to the client prior to use by the commercial artist or designer. The measure of tax for these aids will be computed in the same manner as provided by Regulation 1541 for special printing aids. Intermediate production or printing aids include, but are not limited to, artwork, illustrations, photography, photo engravings, and other similar materials.</p> <p>(3) Signage. Tax does not apply to the services to create single copies of blueprints, diagrams, and instructions for signage provided as a result of environmental graphic design. Reproduction charges for additional copies are taxable.</p> <p>(4) Reproduction Rights. Charges for the transfer by a tangible medium of a photograph or of finished art for purposes of reproduction are taxable even though there is no transfer of</p>	<p>The passage of title of intermediate production or printing aids allows commercial artists and designers the same status as advertising agencies and as printers.</p> <p>Subsection (d)(3) applies tax to environmental graphic design provided by commercial artists and designers in the</p>

Regulation 1540, Advertising Agencies, Commercial Artists and Designers
Comparison of Current Regulations and Amendments Proposed by Staff and Industry
Current as of 9/20/99

Action Item	Current Regulatory Language	Staff's Proposed Regulatory Language	Industry's Proposed Regulatory Language	Comments on Proposed Amendments
		<p>title to the person reproducing the photograph or work of art. Charges for the right to use the photograph or finished art which has been transferred by tangible medium in the production of tangible personal property are taxable. Charges for a license, copyright, or subpart of a copyright (such as a right to reproduce or to prepare derivative works) to exploit the photograph or finished art are taxable if they are sold along with the photograph or finished art transferred by tangible media or they are sold by a subsequent contract entered into within one year of the original transfer of the photograph or finished art.</p> <p>Tax does not apply to a sale of an additional license, copyright, or the subpart of a copyright, or to the receipt of royalties received from the exploitation of a copyright, or subpart thereof, if such sale or receipt of royalties occurs more than one year from the date of the original</p>	<p>title to the person reproducing the photograph or work of art. Charges for the right to use the photograph or finished art which has been transferred by tangible medium in the production of tangible personal property are taxable. Charges for a license, copyright, or subpart of a copyright (such as a right to reproduce or to prepare derivative works) to exploit the photograph or finished art are taxable if they are sold along with the photograph or finished art transferred by tangible media or they are sold by a subsequent contract entered into within one year of the original transfer of the photograph or finished art.</p> <p>Tax does not apply to a sale of an additional license, copyright, or the subpart of a copyright, or to the receipt of royalties received from the exploitation of a copyright, or subpart thereof, if such sale or receipt of royalties occurs more than one year from the date of the original</p>	<p>same manner as it is applied to the same services provided by architects.</p> <p>Subsection (d)(4) defines when a right to reproduce is subject to tax. It also provides that such rights exercised over a year after the original transfer are the exercise of an intangible right and not subject to tax.</p>

Regulation 1540, Advertising Agencies, Commercial Artists and Designers
Comparison of Current Regulations and Amendments Proposed by Staff and Industry
Current as of 9/20/99

Action Item	Current Regulatory Language	Staff's Proposed Regulatory Language	Industry's Proposed Regulatory Language	Comments on Proposed Amendments
		<p>transfer of the physical media containing the photograph or work of art so exploited. Such copyrights or royalties are not considered to have been sold along with finished art transferred by tangible media for the purposes of this subdivision and are deemed sales of nontaxable intangible property.</p> <p>This limitation does not apply to sales or transfers for reproduction by a subsequent owner of the photograph or finished art, such as a stock photo or stock artwork house; however, where the stock photo or stock artwork house is merely acting as an agent for the original artist or photographer, the above limitation applies.</p> <p>(5) Websites. The design, editing or hosting of an electronic website in which no tangible personal property is transferred to the customer is not subject to tax.</p> <p>(e) Items Purchased by Agency or</p>	<p>transfer of the physical media containing the photograph or work of art so exploited. Such copyrights or royalties are not considered to have been sold along with finished art transferred by tangible media for the purposes of this subdivision and are deemed sales of nontaxable intangible property.</p> <p>This limitation does not apply to sales or transfers for reproduction by a subsequent owner of the photograph or finished art, such as a stock photo or stock artwork house; however, where the stock photo or stock artwork house is merely acting as an agent for the original artist or photographer, the above limitation applies.</p> <p>(5) Websites. The design, editing or hosting of an electronic website in which no tangible personal property is transferred to the customer is not subject to tax.</p> <p>(e) Items Purchased by Agency or</p>	

Regulation 1540, Advertising Agencies, Commercial Artists and Designers
Comparison of Current Regulations and Amendments Proposed by Staff and Industry
Current as of 9/20/99

Action Item	Current Regulatory Language	Staff's Proposed Regulatory Language	Industry's Proposed Regulatory Language	Comments on Proposed Amendments
		by Artist or Designer. An advertising agency, or commercial artist, or designer is the consumer of tangible personal property used in the operation of its business. Tax applies to the sale of such property to the agency, artist, or designer.	by Artist or Designer. An advertising agency, or commercial artist, or designer is the consumer of tangible personal property used in the operation of its business. Tax applies to the sale of such property to the agency, artist, or designer.	Subsection (d)(5) provides a specific exemption for services provided in connection with the development of a website.

[1540EX1.DOC]

Regulation 1540. Advertising Agencies, Commercial Artists and Designers.

Reference: Sections 6006, 6010.3 and 6015, Revenue and Taxation Code.

~~(a) Advertising Agency as Agent of Client or as Non Agent.~~

~~—(1) General. An agent is one who represents another, called the principal, in dealings with third persons. (Civil Code, Section 2295.) Advertising agencies may act as agents on behalf of their clients in dealing with third persons or they may act on their own behalf. To the extent advertising agencies act as agents of their clients in acquiring tangible personal property they are neither purchasers of the property with respect to the supplier nor sellers of the property with respect to their principals.~~

~~To the extent advertising agencies act on their own behalf in acquiring tangible personal property they are purchasers of the property with respect to the supplier. Generally, they are sellers of any of the property so acquired which they deliver to, or cause to be delivered to, their clients or to third parties for the benefit of their client. They are also sellers of any of the property which they retain but title to which they transfer to their client.~~

~~—(2) Determination of Status.~~

~~—(A) Items Acquired from Outside Sources. All acquisitions by advertising agencies of tangible personal property such as collateral materials (catalogs, brochures, pamphlets, and the like), artwork (photographs, drawings, paintings, designs, lettering, and the like), and production items (engravings, duplicate plates, mechanicals, assemblies, sound recordings, and the like), are regarded as purchases by the agencies on their own behalf for resale or use unless the agency clearly establishes with respect to any acquisition that it is acting as agent for its client.~~

~~To establish that a particular acquisition was made as agent for its client (i) the agency must clearly disclose to the supplier the name of the client for whom the agency is acting as agent, (ii) the agency must obtain, prior to the acquisition, and retain written evidence of agent status with the client, and (iii) the price billed to the client, exclusive of any agency fee, must be the same as the amount paid to the supplier. The agency may make no use of the property for its own account, such as charging the item to the account of more than one client. An advertising agency purchasing tangible personal property as an agent on behalf of its client may not issue a resale certificate to the supplier. It will be presumed that an advertising agency who issues a resale certificate to its supplier is purchasing the tangible personal property on its own behalf for resale and is not acting as an agent for its client.~~

~~The reimbursement for the property should be separately invoiced, or shown separately on an invoice, to the client.~~

~~—(B) Items Prepared by Agency. Advertising agencies are sellers of all items of tangible personal property produced or fabricated by their own employees. Advertising agencies are not agents of their clients with respect to the acquisition of materials incorporated into items of tangible personal property prepared by their employees.~~

Regulation 1540. Advertising Agencies, Commercial Artists and Designers**(b) Application of Tax to Charges Made by Advertising Agencies.**

~~—(1) Agency Acting as Seller—Sale of Tangible Personal Property. (See subsection (a)(2) for determination of status.) With respect to billings issued by advertising agencies to clients, some charges may represent the sale price of tangible personal property sold to the client by the agency and compensation for expenses incurred in, and service costs related to, the production of the property. Tax applies to the total amount of the retail sale of the property. Tax applies whether the property was prepared by employees of the agency or acquired from an outside source. Whether the items of property are used for reproduction or display purposes is immaterial.~~

~~Tax applies to all charges made for such property, including charges for copy written solely for use as a part of such property. Tax applies to charges for services rendered that represent services that are a part of a sale of the property, or a labor or service cost in the production of the property. Charges for such items as supervision, consultation, research, postage, express, telephone and telegraph messages, and travel expense, if involved in the rendering of such services, are likewise taxable. No deduction may be taken on account of the payment of model fees or talent fees, or for the cost of typography, or for the cost of other services involved in the producing of such items, even though such costs are itemized in the billing rendered to the client.~~

~~If an agency supplies tangible personal property such as finished artwork to a client and the entire payment for such property is included in some other form of compensation such as a fee, commissions or a combination thereof, tax applies to the fair retail selling price of such property.~~

~~“Fair retail selling price” is an amount sufficient to cover (i) the net labor costs of employees of the agency plus an allowance for overhead and profit of not less than 100 percent of such labor cost, and (ii) the cost of purchased items incorporated into the tangible personal property as to which the agency is a seller. If an agency has furnished a firm quoted price based on estimated labor costs plus overhead and profit of not less than 100 percent of the labor cost and bills in accordance with such a quoted price, the agency will be deemed to have charged a fair retail selling price.~~

~~—(2) Agency Acting as Agent—Reimbursement for Property Acquired as Agent. (See subsection (a)(2) for determination of status.) Some charges may represent reimbursement for tangible personal property acquired by the agency as agent for its client and compensation for the performance of agency services related thereto.~~

~~When an advertising agency establishes that it has acquired tangible personal property as agent for its client, tax does not apply to the charge made by the agency to its client for reimbursement including tax reimbursement charged by a supplier or to the charge made for the performance of the agency's services directly related to such acquisitions of personal property.~~

~~—(3) Services and Expenses—When Nontaxable. Some charges may represent the price for the performance of services rendered that do not represent services that are a part of a sale of tangible personal property, or a labor or service cost in the production of such property. Tax does not apply to charges for services rendered that do not represent services that are a part of a sale of~~

Regulation 1540. Advertising Agencies, Commercial Artists and Designers

~~tangible personal property, or a labor or service cost in the production of tangible personal property. Charges for such items as supervision, consultation, research, postage, express, telephone and telegraph messages, and travel expense, if involved in the rendering of such services, are likewise nontaxable.~~

~~—(4) Specific Applications.~~

~~—(A) Preliminary Art. “Preliminary art” means roughs, visualizations, layouts and comprehensives, title to which does not pass to the client but which is prepared by an advertising agency, commercial artist or designer solely for the purpose of demonstrating an idea or message for acceptance by the client before a contract is entered into or before approval is given for preparation of finished art to be furnished by the agency, commercial artist or designer to its client. Tax does not apply to separate charges for preliminary art except where the preliminary art becomes physically incorporated into the finished art, as, for example, when the finished art is made by inking directly over a pencil sketch or drawing, or the approved layout is used as camera copy for reproduction. If the preliminary art is prepared on data processing equipment, the advertising agency, commercial artist, or designer shall produce a hard copy of each of the roughs, visualizations, layouts or comprehensives presented for client approval and retain such copies in accordance with subdivision (d) of Regulation 1698.~~

~~The charge for preliminary art must be billed separately to the client, either on a separate billing or separately charged for on the billing for the finished art. It must be clearly identified on the billing as preliminary art. Proof of ordering or producing the preliminary art, prior to the date of the contract or approval for finished art, shall be evidenced by purchase orders of the buyer, or by work orders or other records of the agency, commercial artist or designer. No other proof shall be required.~~

~~—(B) Finished Art. “Finished art” means the final art used for actual reproduction by photo mechanical or other processes; or for display purposes including charts, graphs, and illustrative materials not reproduced. Tax applies to the total charges made by advertising agencies, commercial artists or designers to their clients for finished art produced by them.~~

~~—(C) Consultation and Research. Tax applies to charges for consultation and research if the consultation or research relates solely to tangible personal property as to which the agency is acting as a seller. Tax does not apply to such charges in other circumstances, including those in which the agency is acting as agent, or where research charges relate to advertising testing even though the agency may have been the seller of tangible personal property used in conveying the advertising message.~~

~~—(D) Supervision. Tax applies to charges for supervision if the supervision relates directly and solely to tangible personal property as to which the agency is acting as a seller, for example, supervision of an art department engaged in the production of tangible personal property sold to a client. Tax does not apply when the agency is acting as agent or when charges for supervision do not relate solely to tangible personal property.~~

Regulation 1540. Advertising Agencies, Commercial Artists and Designers

~~—(E) Copy Writing. Tax applies to charges for writing copy written solely for use as a part of tangible personal property as to which the agency is acting as a seller. Tax does not apply to such charges in other circumstances or when the agency is acting as agent.~~

~~Tax does not apply where copy is furnished to media in manuscript form.~~

~~—(F) Typography Charges, Model Fees, Talent Fees. Tax applies to charges for typography, model fees (including reuse payments), and talent fees (including residual payments), made by agencies to their clients when such fees are part of the charge for tangible personal property sold by the agency. Tax does not apply to such charges or fees when the agency acts as agent.~~

~~—(G) Motion Picture Productions. Tax applies to motion picture productions, including those for television, in the manner set forth in Regulation 1529, “Motion Pictures”.~~

~~—(H) Purchase Agent Fees. Fees added to purchases of tangible personal property by agencies established as agents for their clients as compensation for their performances of services related to such purchases are not taxable.~~

~~—(I) Media Commissions. Commissions derived by agencies for placement of advertising are not taxable whether paid by the medium, by another agency, or by the client. The service of placing of advertising is not a service that is a part of a sale of tangible personal property.~~

~~—(J) Supplier Commissions. Commissions paid to agencies by suppliers are not taxable receipts of the agencies. Examples of such nontaxable commissions would be commissions paid to an agency by a premium manufacturer (or distributor) or a direct by mail supplier.~~

~~—(K) Fee Added to a Total Billing. The term “fee” as used herein means a general over-all fee encompassing all agency services performed for the client. Such fees may be fixed or based on agency costs and are generally in lieu of commissions, fees added to purchases, and separate time charges added to jobs or agency projects or any combination thereof.~~

~~A fee added by an agency to a total billing encompassing items as to which the agency is a seller and items as to which tax does not apply is taxable in accordance with the ratio between the charges for the items as to which the agency is a seller and the charges for nontaxable items if the agency performed no duties as an agent of its client, within the standards set forth in (a)(2)(A), during the course of its performance under the contract with its client.~~

~~A fee added to a total billing encompassing taxable and nontaxable elements is not taxable if the agency has acted as agent for its client with respect to the acquisition of tangible personal property acquired for the client from outside sources, provided the taxable items are billed at their fair retail selling price.~~

~~If an agency which has acted as agent of its client fails to bill the items as to which it is a retailer at their fair retail selling price, as defined in (b)(1) above, the fee added to the billing is taxable in accordance with the ratio between the taxable and nontaxable charges.~~

Regulation 1540. Advertising Agencies, Commercial Artists and Designers

~~(L) Retouching. Retouching ordinarily constitutes a step in the process of preparing photographs or other artwork for reproduction, and is done to improve the quality of the reproductions. Tax applies to charges for photo retouching unless it can be clearly demonstrated that the retouching is done only for the purpose of repairing or restoring a photograph to its original condition.~~

~~(c) Commercial Artists and Designers. The tax applies to the entire amount charged by commercial artists or designers for items of tangible personal property such as drawings, paintings, designs or sketches transferred to the client, whether or not the property is suitable for display or is useful for actual reproduction by photo-mechanical or other processes.~~

~~Tax does not apply to separate charges for preliminary art as defined in (b)(4)(A).~~

~~(d) Items Purchased by Agency or by Artist or Designer. An advertising agency, artist, or designer is the consumer of tangible personal property used in the operation of its business. Such property may include stationery, ink, paint, tools, drawing tables, T squares, pens, pencils, and other office supplies. Tax applies to the sale of such property to the agency, artist, or designer.~~

~~The agency, artist, or designer is the seller of, and may purchase for resale, any tangible personal property that it resells before use, or that becomes physically an ingredient or component part of tangible personal property sold by it prior to use. Such property may include illustration board, paint, ink, rubber cement, flap paper, wrapping paper.~~

~~An advertising agency, artist, or designer is the consumer of property such as photographs and art which it uses in the preparation of tangible personal property as to which it is acting as a seller unless, prior to any use having been made of the property, the property is sold or becomes an ingredient or component part of other tangible personal property sold. The agency, artist, or designer may purchase for resale photographs and art which, prior to any use, are sold or become physically an ingredient or component part of other tangible personal property that is sold by the agency, artist, or designer.~~

~~The term "ingredient or component part of other tangible personal property" includes only those items that become physically incorporated into the property sold and not those which are merely consumed or used in the production of the property sold. A photograph, for example, does not become an ingredient or component part of property sold merely because the image of the photograph is reproduced as part of the property sold. A photograph or art is regarded as having been used when a reproduction is made from the photograph or art.~~

(a) Advertising Agencies.

(1) General. Advertising agencies provide clients with both services and tangible personal property. Services include, without limit, consultation, consumer research, and media placement. Tangible personal property includes, without limit, video and audio productions, print

Regulation 1540. Advertising Agencies, Commercial Artists and Designers

advertisements, brochures, finished artwork, and other printed matter. When an advertising agency provides services unrelated to the transfer of tangible personal property or when the tangible personal property transferred is incidental to the services, the charges for those services are nontaxable.

Application of tax to the sale of tangible personal property and any services related to the sale is dependent on the type of property being sold and the relationship of the advertising agency to the client.

(2) Specific Situations.

(A) Electronic or Digital Artwork. Electronic or digital art is the process of using computer software and hardware to compile or compose finished art. Elements of the process include: creation of original artwork or photographs, scanning of artwork or photographs, composition and design of text, insertion and manipulation of scanned and original digital artwork, photographs, or text.

A transfer of electronic or digital art from an advertising agency, commercial artist or designer to a client or to a third party on behalf of a client that includes text or images or a combination of both, is not taxable if, (1) the file containing the electronic or digital art is transferred through remote telecommunications, such as a modem, or (2) the file is downloaded on the client's computer by the advertising agency, commercial artist or designer and the client does not obtain title to or possession of any tangible personal property, such as a diskette or compact disk. The advertising agency, commercial artist, or designer should document the downloading of electronic artwork in the manner set forth in subsection (d)(2). Transfer of a file qualifying as electronic or digital pre-press instruction as defined by the provisions of Regulation 1541, *Printing and Related Arts*, is nontaxable.

A transfer of title to or possession of a file on electronic media, such as a diskette or compact disc, is subject to tax as stated in subdivision (d)(2).

(B) Agency Acting as an Agent for Its Client. An agent is one who represents another, called the principal, in dealings with third persons. (Civil Code, Section 2295.) To the extent an advertising agency acts as an agent of its client in acquiring tangible personal property, it is neither a purchaser of the property with respect to the supplier nor a seller of the property with respect to its principal. Because of the unique relationship between advertising agencies and clients, it is rebuttably presumed that an advertising agency qualifies as an agent when acquiring tangible personal property on behalf of its client. However, an agency is not an agent of its client with respect to tangible personal property fabricated or produced in-house by the agency's own employees and sold to its client.

As an agent for its client, sales or use tax is due on the purchase price from the suppliers to the advertising agency. Tax does not apply to the charge made by an advertising agency to its client for reimbursement, including tax reimbursement, charged by a supplier or to charges or fees for an agency's services directly related to such acquisitions of tangible personal property.

Regulation 1540. Advertising Agencies, Commercial Artists and Designers

An advertising agency may not issue a resale certificate when making purchases as an agent. It will be presumed that an advertising agency who issues a resale certificate to a supplier is purchasing tangible personal property on its own behalf for resale and is not acting as an agent for its client. However, the advertising agency may provide evidence to prove that the presentation of the resale certificate was erroneous and that the advertising agency was acting as an agent of its client. If the resale certificate was issued in error, the advertising agency is liable for use tax on the cost of tangible personal property purchased under the certificate unless, 1. The agency has already paid tax to the supplier or to the Board, or 2. The client has self-reported the tax.

(3) Advertising Agencies Acting as Retailers

(A) Election of Non-Agent Status. An advertising agency may elect non-agent status with respect to sales to its client. This election must be supported by a specific written statement in its contract or agreement with the client. Alternatively, a statement may be included on an agency's invoice to its client. Statements should include the following or similar language: "(Agency name) does not qualify as an agent of (client name) for purposes of this transaction."

An agency that elects non-agent status is a retailer with respect to tangible personal property sold to its clients. The agency may issue a resale certificate to its suppliers for tangible personal property that it is planning to resell to clients or to incorporate into property that will be sold to clients.

The taxable selling price is the separately stated charge for the tangible personal property. If there is no separately stated charge, the taxable selling price may be calculated as shown in subdivision (b).

(B) Items Produced or Fabricated by an Agency In-house. Advertising agencies are retailers of tangible personal property produced or fabricated by their own employees. Advertising agencies are not agents of their clients with respect to the acquisition of materials incorporated into items of tangible personal property prepared by their employees. However, in the case of intermediate production or printing aids used by the agency's employees to fabricate tangible personal property, it will be presumed that an advertising agency passes title to the aids to the client prior to use by the agency and the measure of tax will be computed in the same manner as provided in Regulation 1541 for special printing aids. Intermediate production or printing aids include, but are not limited to, artwork, illustrations, photography, photo engravings, and other similar materials.

Except for artwork, tax is due on the taxable selling price of tangible personal property fabricated or produced by the agency's employees. Artwork shall be taxed in the manner set forth in subsection (b)(1) or (d)(1). An advertising agency should issue a resale certificate for items that become an ingredient or component part of such tangible personal property and for intermediate production or printing aids. The term "ingredient or component part of other tangible personal

Regulation 1540. Advertising Agencies, Commercial Artists and Designers

property” includes only those items that become physically incorporated into the property and not those which are merely consumed or used in the production of the property sold.

(b) Lump-sum Sales of Tangible Personal Property.

(1) An agency that has a contract or agreement to sell tangible personal property for a lump-sum amount is a retailer of the tangible personal property and tax applies to the lump-sum selling price, except for artwork. An advertising agency, commercial artist or designer making a lump-sum sale of tangible personal property to a client may issue a resale certificate to a supplier.

On sales of artwork for which an advertising agency, commercial artist or designer makes a lump-sum charge that includes both the nontaxable services defined in subsection (d)(1) and finished art, it will be rebuttably presumed that 75% of the lump-sum charge is for the nontaxable services.

(2) **Taxable Selling Price.** If advertising agencies, commercial artists or designers combine charges for nontaxable services, such as media placement, with the charges for tangible personal property of which the agencies, artists or designers are the retailers, they shall report a “taxable selling price” for the tangible personal property that includes the total of: 1. direct labor, 2. the cost of purchased items that become an ingredient or component part of the tangible personal property and the cost of any intermediate production or printing aids, and 3. a reasonable markup. An advertising agency, commercial artist or designer must keep sufficient records to document the basis for the reported taxable selling price.

(3) Specific Nontaxable Charges. The following and similar fees, commission, and services are nontaxable if separately stated. If not separately stated, these charges are not considered direct labor when calculating a taxable selling price as defined in subdivision (b).

(A) Agent fees added to purchases of tangible personal property by agencies established as agents for their clients as compensation for their performances of services related to such purchases.

(B) Media commissions derived by agencies for placement of advertising whether paid by the medium, by another agency, or by the client. The service of placing of advertising is not a service that is a part of a sale of tangible personal property.

(C) Commissions paid to agencies by suppliers. Examples of such commissions are those paid to an agency by a premium manufacturer (or distributor) or a direct-by-mail supplier.

(D) Consultation and concept development fees related to client discussion, development of ideas and other services. Tangible personal property produced as a result of these services is incidental to the service and nontaxable.

(E) Research or account planning that entail consumer research and the application of that research to the client’s business or industry.

Regulation 1540. Advertising Agencies, Commercial Artists and Designers

(F) Quality control supervision that entails the proofing and review of printing and other products provided by outside vendors.

(G) Separately stated charges for the formulation and writing of copy.

(4) Taxable Charges for Agencies Acting as Retailers. All other commissions, fees or services exclusively related to the production or fabrication of tangible personal property are taxable and are considered part of direct labor. Such charges include retouching of photographs or other artwork for reproduction, provided the retouching is intended to improve the quality of the reproduction. Retouching for the purpose of repairing or restoring a photograph to its original condition is not taxable.

(5) Charges and Transactions Governed by Other Regulations.

(A) Video or Film Productions. If video or film productions provided by an advertising agency to clients are qualified production services, the application of tax is determined by Regulation 1529, *Motion Pictures*.

(B) Audio Productions. An audio production provided by an advertising agency to a client falls under the provisions of Regulation 1527, *Sound Recording*. Tax will apply as defined by that regulation.

(C) Typography. Tax applies to charges for typography or composed type obtained from outside vendors as provided in Regulation 1541, *Printing and Related Arts*.

(c) Commercial Artists and Designers

General. Commercial artists and designers provide services, electronic artwork, and tangible personal property to their clients. Services include, but are not limited to, the creation and development of ideas, concepts, looks, or messages. Electronic artwork can be transferred either through remote telecommunications, such as a modem, or by electronic media such as diskettes or compact disks. Tangible personal property includes both electronic media on which electronic artwork is transferred to the client and hard copies of the electronic artwork, or manually created art. "Finished art" means the final art used for actual reproduction by photomechanical or other processes, or used for display. It includes, but is not limited to, electronic art, illustrations (e.g. drawings, diagrams, halftones, or color images), photographs, paintings, and handlettering. Blueprints, diagrams, and instructions for signage furnished to a client as the result of environmental graphic design services are not "finished art."

An advertising agency that provides creative or development services for the sole purpose of furnishing finished art to their clients is subject to tax as provided in subsection (d).

(d) Application of Tax to Commercial Artists and Designers

Regulation 1540. Advertising Agencies, Commercial Artists and Designers

(1) **Services.** Services performed to convey ideas, concepts, looks or messages to a client may result in a transfer, enhancement or revision of either electronic artwork, hard copies of electronic artwork, or copies of manually prepared artwork. If charges for such services are separately stated as “design charges,” “preliminary art,” “concept development,” or any other designation that clearly indicates that the charges are for such services and not for finished art, they are nontaxable unless the contract of sale provides that the commercial artist or designer will pass to the client title or the right to permanent possession of the electronic media or hard copy.

A commercial artist or designer who provides nontaxable services is the consumer of tangible personal property used in the performance of such services and tax applies to the sale of property to the commercial artist or designer.

(2) **Electronic Artwork and Finished Art.** A transfer of electronic artwork from a commercial artist or designer to a customer or to a third party on behalf of the customer is not taxable if the file containing the electronic artwork is transferred through remote telecommunications, or if the file is loaded on the customer’s computer by the commercial artist or designer, and the customer does not obtain title to or possession of any tangible personal property, such as electronic media. The graphic artist should document his or her transfer and loading of electronic artwork on the client’s computer by a statement on the invoice or contract with the following language: “This electronic artwork was loaded onto my computer by (graphic artist’s or seller’s name). No electronic media, such as diskettes or compact disks, or hardcopies containing the artwork were transferred to me.” This statement should be signed or initialed by the client. When such a statement is timely completed, it will be rebuttably presumed that the transfer of electronic artwork is nontaxable. To be timely completed, the statement must be initialed or signed at the time the file is loaded or at the point the transfer is invoiced to the client. In lieu of the statement, the commercial artist or designer may provide other substantive evidence indicating that the artwork was transferred in an exempt manner.

The electronic or manual preparation of finished art for use in reproduction or display is not a service. Unless transferred or installed in the manner set forth in the preceding paragraph, tax applies to all charges for finished art, including to all charges for any rights, as provided in subdivision (d)(4), sold with the finished art, such as, without limitation, copyrights or distribution and production rights. If charges for finished art are combined with nontaxable services described in subdivision (d)(1), tax may be reported on a calculated selling price, as defined in subsection (b)(2) provided the retail selling price also includes the value of rights as provided in subdivision (d)(4). In lieu of using a calculated selling price, commercial artists and designers may use the method described in (b)(1), that is, it will be rebuttably presumed that 75% of a combined charge is for the nontaxable services.

If the commercial artist or designer uses any intermediate production or printing aids in the creation of the finished art, it will be presumed that title to the aids was passed to the client prior to use by the commercial artist or designer. The measure of tax for these aids will be computed in the same manner as provided by Regulation 1541 for special printing aids. Intermediate

Regulation 1540. Advertising Agencies, Commercial Artists and Designers

production or printing aids include, but are not limited to, artwork, illustrations, photography, photo engravings, and other similar materials.

(3) **Signage.** Tax does not apply to the services to create single copies of blueprints, diagrams, and instructions for signage provided as a result of environmental graphic design. Reproduction charges for additional copies are taxable.

(4) **Reproduction Rights.** Charges for the transfer by a tangible medium of a photograph or of finished art for purposes of reproduction are taxable even though there is no transfer of title to the person reproducing the photograph or work of art. Charges for the right to use the photograph or finished art which has been transferred by tangible medium in the production of tangible personal property are taxable. Charges for a license, copyright, or subpart of a copyright (such as a right to reproduce or to prepare derivative works) to exploit the photograph or finished art are taxable if they are sold along with the photograph or finished art transferred by tangible media or they are sold by a subsequent contract entered into within one year of the original transfer of the photograph or finished art.

Tax does not apply to a sale of an additional license, copyright, or the subpart of a copyright, or to the receipt of royalties received from the exploitation of a copyright, or subpart thereof, if such sale or receipt of royalties occurs more than one year from the date of the original transfer of the physical media containing the photograph or work of art so exploited. Such copyrights or royalties are not considered to have been sold along with finished art transferred by tangible media for the purposes of this subdivision and are deemed sales of nontaxable intangible property.

This limitation does not apply to sales or transfers for reproduction by a subsequent owner of the photograph or finished art, such as a stock photo or stock artwork house; however, where the stock photo or stock artwork house is merely acting as an agent for the original artist or photographer, the above limitation applies.

(5) **Websites.** The design, editing or hosting of an electronic website in which no tangible personal property is transferred to the customer is not subject to tax.

(e) **Items Purchased by Agency or by Artist or Designer.** An advertising agency, or commercial artist, or designer is the consumer of tangible personal property used in the operation of its business. Tax applies to the sale of such property to the agency, artist, or designer.